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The Effectiveness and Economic Development Impact of Policy-Based Cash Transfer Programs: The Case of Costa Rica

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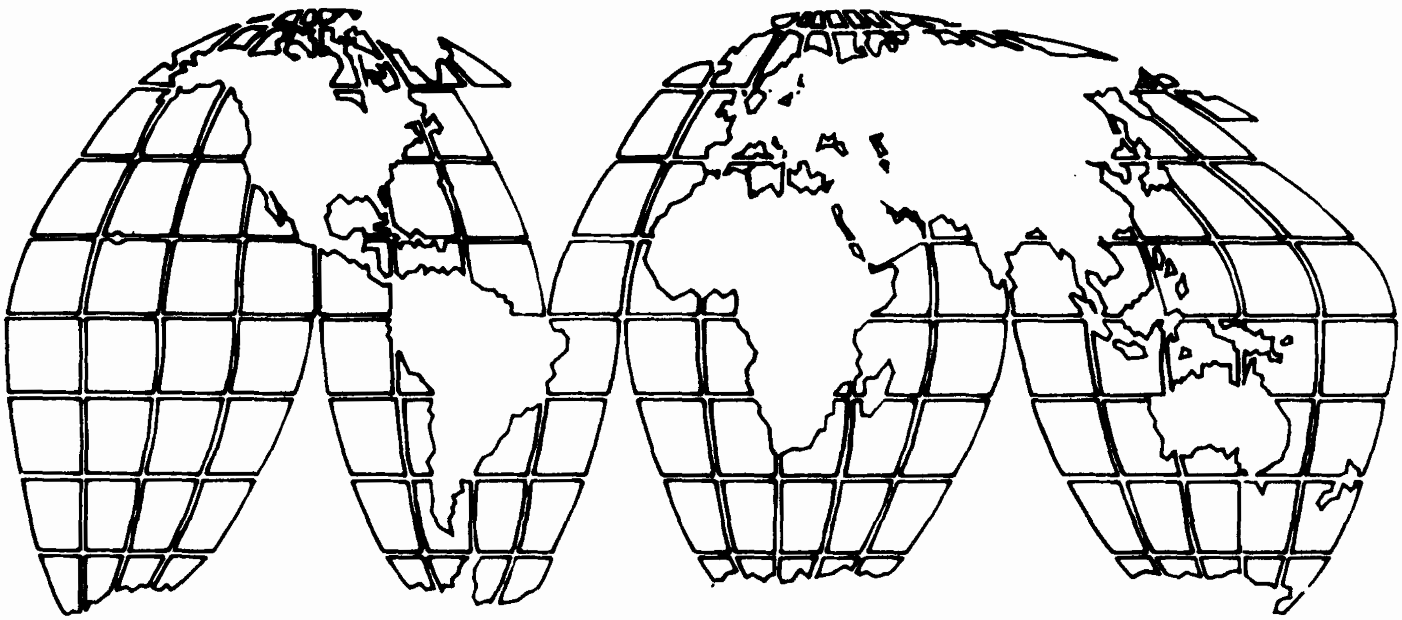

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THE EFFECTIVENESS AND ECONOMIC DEVELOPMENT IMPACT OF POLICY-BASED CASH TRANSFER PROGRAMS: THE CASE OF COSTA RICA

A.I.D. EVALUATION SPECIAL STUDY NO. 57

by

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November 1988

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FOREWORD

Many developing countries have adopted policies that include market and price controls, along with subsidies and special incentives designed to spur economic growth. All too often, however, such policies have had the opposite effect, encouraging inefficient and high-cost production. In the early 1980s, the problems resulting from inappropriate economic policies were compounded as the price of oil and other commodities rose sharply and the worldwide recession of 1981-1982 took hold. During this period, most developing countries went into an economic tailspin.

In the early 1980s, A.I.D. worked closely with several developing countries on economic restructuring and reform pro- [illegible] jor macroeconomic and sectoral reform efforts [illegible] reorganize and reinvigorate economies facing [illegible] f payments pressures, mounting debt problems, rapid inflation, declining export and investment performance, and stagnant or declining economic growth. A.I.D. provided quick-disbursing nonproject assistance, with disbursements conditioned upon the developing country's adoption of a policy reform program. In the Latin America and Caribbean region, policy reform programs were funded through Cash Transfer programs.

A.I.D. has not routinely evaluated nonproject assistance, including Cash Transfer programs. But empirical data on the effectiveness and economic development impact of these programs is clearly needed to help in the design and implementation of future policy reform programs. Such information will also help A.I.D. in developing the proper mix of project and nonproject assistance and, within nonproject assistance, the proper mix of Cash Transfer programs, Commodity Import programs, and PL 480 assistance.

A.I.D.'s Center for Development Information and Evaluation (CDIE) worked closely with A.I.D.'s Bureau for Latin America and the Caribbean on a series of evaluation studies of Cash Transfer programs in countries that had adopted Cash Transfer-based policy reform programs. The countries included in the study were Costa Rica, Jamaica, Honduras, and the Dominican Republic.

Each evaluation first looked at the resources A.I.D. provided, along with the policy covenants and conditions that were applied. Next a series of performance indicators were developed to measure performance in each policy category, and finally the economic development impacts of the policy changes were examined.

The Costa Rican reform program was the first to be evaluated. The program was of particular interest because A.I.D.-supported reforms helped pull the economy out of a major economic depression. Also, Costa Rica demonstrates the importance of effective markets, institutions, infrastructure, and a dynamic private sector, which are the factors that must respond in support of new policy incentives.

W. Haven North
Associate Assistant Administrator
Center for Development Information and Evaluation
Bureau for Program and Policy Coordination
Agency for International Development
November 1988

PREFACE

This report is the first in a series of comparative studies of the effectiveness and economic development impact of Cash Transfer-based policy reform programs. It was prepared for the Agency for International Development (A.I.D.) by Robert R. Nathan Associates, Inc. and was managed by A.I.D.'s Center for Development Information and Evaluation (CDIE). The basic scope of work for the series was jointly designed by CDIE and A.I.D.'s Bureau for Latin America and the Caribbean.

The research involved in preparing this report was carried out by a joint Robert R. Nathan Associates, Inc./A.I.D. research team over a 5-week period during September and October 1987. The A.I.D. team participants included Joseph Lieberson (the Project Officer) and Devorah Miller, both of CDIE, and James Fox and Clarence Zuvekas of the Bureau for Latin America and the Caribbean. The Team Leader was Dr. John Newton; Dr. Richard Sines served as Program Analyst.

The research team would like to thank Acting USAID/Costa Rica Mission Director Richard Archi for his active cooperation and that of his staff during the performance of this evaluation. Robert Adler and Minor Sagot of the Economic Affairs Office were especially helpful in providing necessary statistical material and logistical support. Kevin Kelley, Lewis Lucke, and Lorraine Simard also provided support and information on Mission tracking and administration of the Cash Transfer system.

Thanks are also due to Eduardo Lizano, President of the Central Bank of Costa Rica, and his staff for their help during the policy analysis phase of the team's research.

SUMMARY

Macroeconomic Trends

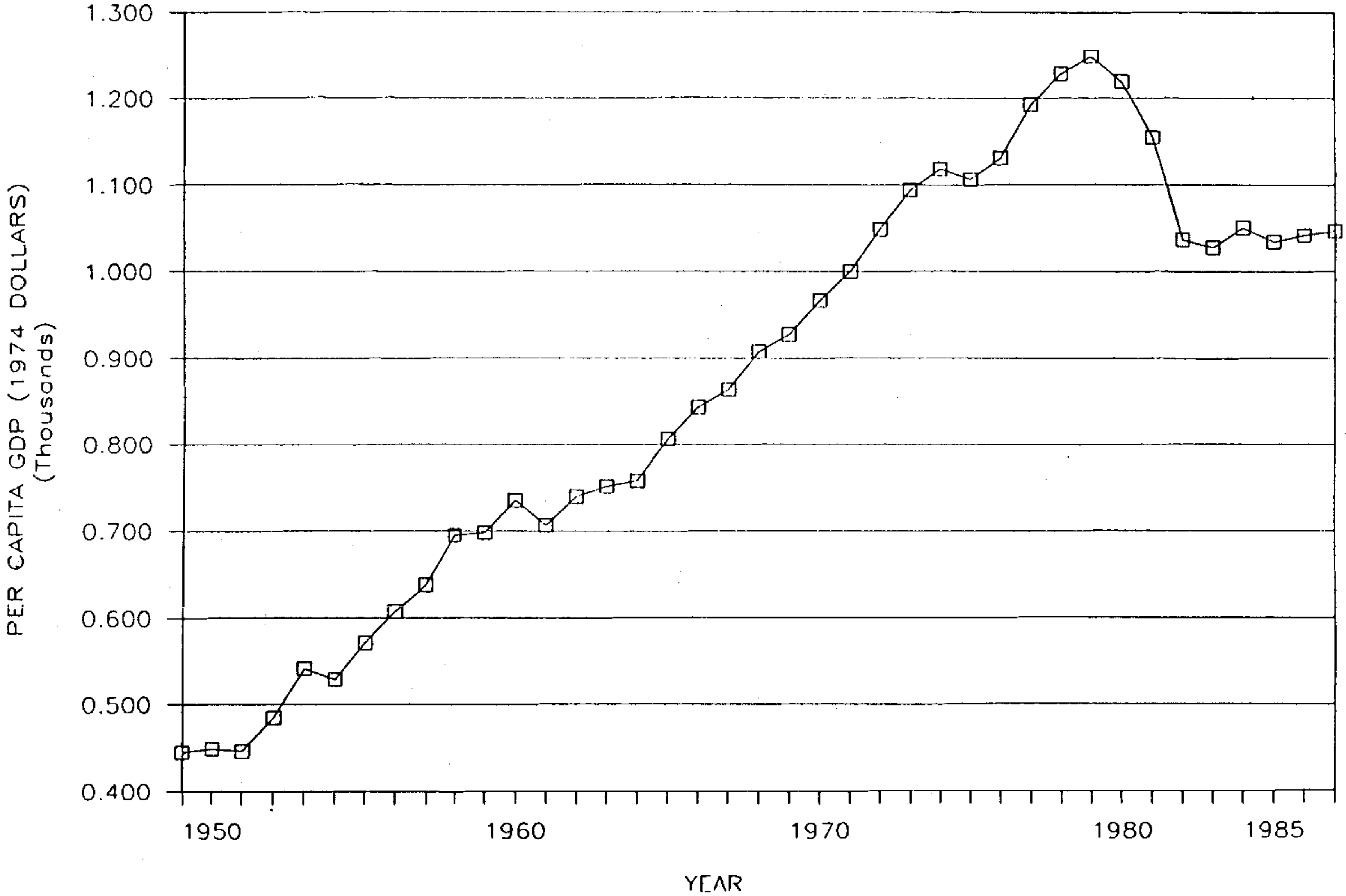
Prior to the economic crisis of the early 1980s, Costa Rica's economy, especially its external sector, grew at a healthy pace, with gross national product (GNP) averaging 6.5 percent annual real growth between 1960 and 1980. However, that growth concealed certain structural weaknesses that were revealed by the economy's response to the international commodity price fluctuations of 1981 through 1983. The country depended largely on traditional agricultural exports and exports to the Central American Common Market (CACM), and the industrial sector was highly protected by CACM common tariffs and other policies. At the same time, the private sector was unable to develop freely due to significant Government intervention in the economy via price controls, subsidies, public sector ownership, and a nationalized banking system.

Even before the financial and economic crisis of the early 1980s, Costa Rican public sector policy in general, and fiscal policy in particular, had gotten out of hand. The central Government deficit averaged 6.2 percent of gross domestic product (GDP) from 1978 to 1981, peaking at 8.0 percent in 1980 (see Figure 3 in main report and Appendix Table B-9).

Given these structural defects, the Costa Rican economy was unable to adjust to the international economic displacements of the 1981-1983 period. World markets for all four of the country's traditional exports (beef, sugar, coffee, and bananas) deteriorated, and the CACM virtually collapsed due to payment difficulties. By 1982, real per capita GDP had fallen to 86 percent of its 1980 level and both investment and consumption had declined sharply (see Figure i). Costa Rica's external public debt increased 8 percent per year from 1981 through 1985, reaching $3.7 billion (102 percent of GDP) at the end of 1985. This response to the economic crisis was clearly unsustainable.

The Government of Costa Rica, in conjunction with A.I.D., the World Bank, and the International Monetary Fund (IMF), designed an economic policy reform program that included significant international assistance. The impacts of these economic policy reforms and attendant international assistance are the subject of this report.

Figure i. Costa Rica: Real Per Capita Income, 1949-1987



Multilateral Stabilization and Structural Adjustment Programs

Quantitatively speaking, the World Bank and IMF programs in Costa Rica are not nearly as important as the A.I.D. Cash Transfer program: together their total funding is less than the funding available under the Cash Transfer program, and, of course, they are loans, not grants. However, their policy impact is more than proportionate to their financial contribution. Prior to the Kemp-Kasten Act of 1984, the conditionality of the Cash Transfer program was expressly based on IMF and World Bank conditionality. In later years, the conditionality of the three programs has been consistent, although not interlocking.

IMF lending to Costa Rica has sought to achieve short-term stability, especially in the external accounts. Policy reform has been directed at limiting public sector growth, controlling fiscal deficits, and improving the balance of payments. However, the success of IMF programs has been limited, with only one of the first four agreements having been successfully completed. Since 1981, Costa Rica has been out of strict compliance with IMF programs for more time than it has been in compliance. It is possible that IMF conditionality, especially with regard to fiscal performance, has been too strict or at least too strictly interpreted. In general terms, however, the IMF program has been consistent with the objectives of the A.I.D. program.

World Bank conditionality has been more flexibly applied in Costa Rica, as has the Bank's Structural Adjustment Loan (SAL) program in general. SAL I was for $80 million and was released in two tranches during 1985 and 1986. That program has had the longer term objective of promoting export-led growth via reforms in economic structure and public policy. Conditionality provisions have focused on reforming trade policy, controlling public sector growth, and improving external debt management. In contrast to the IMF experience, World Bank negotiations and disbursements have progressed smoothly. A second SAL is currently being negotiated.

Due to the close coordination of the policy programs of the three major international organizations operating in Costa Rica, the impacts of the programs are difficult to separate. In most cases, the evaluation team has treated the policy impacts analyzed in this report as being due jointly to the Government of Costa Rica and international policy programs. In some cases, however, particular impacts can be shown to be the result of the A.I.D. Cash Transfer program.

Dollar Transfers Under the A.I.D. Cash Transfer Program

The A.I.D. Cash Transfer program comprises both direct dollar transfers and a local currency program. Direct dollar transfers are similar to the IMF and World Bank programs in that they are used essentially for balance of payments support and are conditioned on fairly direct policy guidelines and covenants (conditionality).

Since 1982, the A.I.D. Cash Transfer program in Costa Rica has progressed through six annual iterations--Economic Stabilization and Recovery (ESR) Agreements I through VI--totaling approximately $800 million. The ESRs have become the dominant component of A.I.D. activity in Costa Rica, representing 83 percent of the USAID/Costa Rica program in 1987. The Cash Transfers are large compared to the size of the Costa Rican economy, averaging 3.8 percent of GDP and reaching as high as 5 percent of GDP.

Dollar transfers have been successful in meeting their short-term objective of providing balance of payments support to Costa Rica. Since 1983, Cash Transfers have provided 12.8 percent of the total foreign exchange needed to finance Costa Rica's imports. The longer term objective of the program, however, is to enable Costa Rica to provide for its own foreign exchange needs via policy reform and restructuring. This objective is expressed in the covenants attached to the various ESRs.

Nearly half the covenants for ESRs I through VI have been directed at the Costa Rican financial sector. Of these, most have encouraged the allocation of credit to the private sector and have tended to channel that credit through the nascent private banking sector. Others have supported the liberalization of the financial system through the deregulation of interest rates and banking activities.

Two additional public policy objectives have been strongly supported by ESR covenants: export promotion and privatization of public holdings. Through its allocation of foreign exchange, A.I.D. has supported the expansion of the export-oriented private sector and has helped maintain employment and productive capacity in that sector during what would otherwise have been a severe recession. At the same time, Cash Transfer conditionality promoted the unification of Costa Rican exchange rates and the creation of the highly successful Costa Rican Coalition for Development Initiatives (CINDE), a private sector investment promotion agency. In terms of privatization, several ESR covenants established the timetable and procedures for divestiture of the state holding company, the Costa Rican Development

Corporation (CODESA). This process has proceeded more slowly than scheduled, but does appear to have achieved identifiable goals.

The administration of dollar funds under the Cash Transfer program has been fairly straightforward, although the procedures were modified for FY 1987 (ESR VI). Standard A.I.D. documentation is prepared and reviewed for each ESR prior to its approval and prior to the formal agreement between the Government of Costa Rica and USAID/Costa Rica on the budgeting and disbursement of funds. After final A.I.D./Washington review, approval, and signing of the Project Agreement, the process of A.I.D. certification of Costa Rican Government performance of conditionality begins. Formerly, a major element of that conditionality--certification that eligible Costa Rican imports from the United States at least match Cash Transfer disbursements--could be attributed ex post, after dollar disbursements. Beginning with ESR VI, that certification must be made prior to disbursement and documented item by item.

The U.S. Treasury pays Cash Transfer dollar funds into a Costa Rican Government account in the United States upon receiving notification from A.I.D./Washington that USAID/Costa Rica has provided certification of conditions met. Again, beginning with ESR VI, those funds must be kept in a separate account and not commingled with other Costa Rican Government funds in order to allow separate tracking and accounting.

In the process of designing and monitoring Cash Transfer conditionality, one of A.I.D.'s major objectives is the establishment of policy dialogue with the Government of Costa Rica, as opposed to the simple imposition of conditions. At one level, the Cash Transfer program has been successful in this respect: Costa Rican officials from both the executive and legislative branches actively participate in the design of and discussions about conditionality. At another level, however, the program has not been successful: the Government of Costa Rica has not developed significant policy analysis capacity. A recommendation resulting from this evaluation is that A.I.D. encourage the establishment of economic policy analysis offices for both the Costa Rican presidency and the legislature.

Local Currency Programs

The Cash Transfer program in Costa Rica "generates" local currency in that the Central Bank of Costa Rica deposits an amount of colones equivalent to each dollar disbursement in an "A.I.D. Special Account" for use on joint A.I.D./Government of

Costa Rica projects. Because many of these funds are eventually removed from active circulation in the economy (i.e., sterilized), they do not represent inflationary credit creation on the part of the Central Bank. The projects funded by local currency are jointly agreed upon by USAID/Costa Rica and the Government of Costa Rica, but as of the time of this evaluation they have not been subject to Costa Rican Government legislative scrutiny and approval. It appears that the legislature will have to be involved in future programs.

The evaluation team analyzed the impacts of local currency projects in terms of the same policy categories used in analyzing impacts from dollar transfers, and the pattern of impacts turned out to be similar. Most local currency projects were private sector-oriented (42 percent of expenditures), with a large portion of those supporting export-oriented industry. The first ESR created CINDE with local currency funding, and that agency has since achieved significant success in promoting investment (both foreign and domestic) in nontraditional export industries.

Local currency funding also supported the CODESA divestiture. This large-scale privatization project represents a creative use of sterilized currency: the funds are used as an accounting entry to "pay" the Government of Costa Rica the difference between the (higher) book value of public holdings and the (lower) market value when they are actually sold. This difference in price is never "spent" by the Government of Costa Rica or any other party and thus does not negatively affect the economy.

The final major programmed use of local currency funds has been for the Agricultural School for the Humid Tropics (EARTH). The evaluation team questions the advisability of a project of this size under the Cash Transfer program (24 percent of total local currency funding to date) without demonstration of acceptable rates of return, but a full evaluation of the project is not yet possible.

USAID/Costa Rica's management and tracking system for local currency projects appears to be well designed, and as of the latest ESR, projects are completely documented and updated by computer. But even for such an advanced tracking system, the sheer number of local currency projects in Costa Rica is quite high: the Mission has attempted to monitor 120 separate local currency projects. Limiting local currency projects to 10 to 15 a year would allow more attention to be directed to project selection and management.

Two remaining issues concerning the administration of local currency funds are the appropriate ownership of those funds and the payment of interest by the central bank on the A.I.D. Special Account. These two issues are likely to be resolved by A.I.D. as a worldwide policy decision in 1988. Likely resolution will mandate that the central bank pay interest on unused local currency funds and that formal ownership of local currency funds be assigned to the host country government.

Economic Development Effects of Policy Programs

The A.I.D. Cash Transfer program, in conjunction with the IMF and World Bank programs, has generally had beneficial impacts on the Costa Rican economy. The following effects, by policy category, are detailed in the main report.

-- Production and private sector performance. The CODESA divestiture and the support of private banking have strengthened Costa Rica's private sector and increased its productivity. In addition, CINDE has promoted new investment and new jobs.

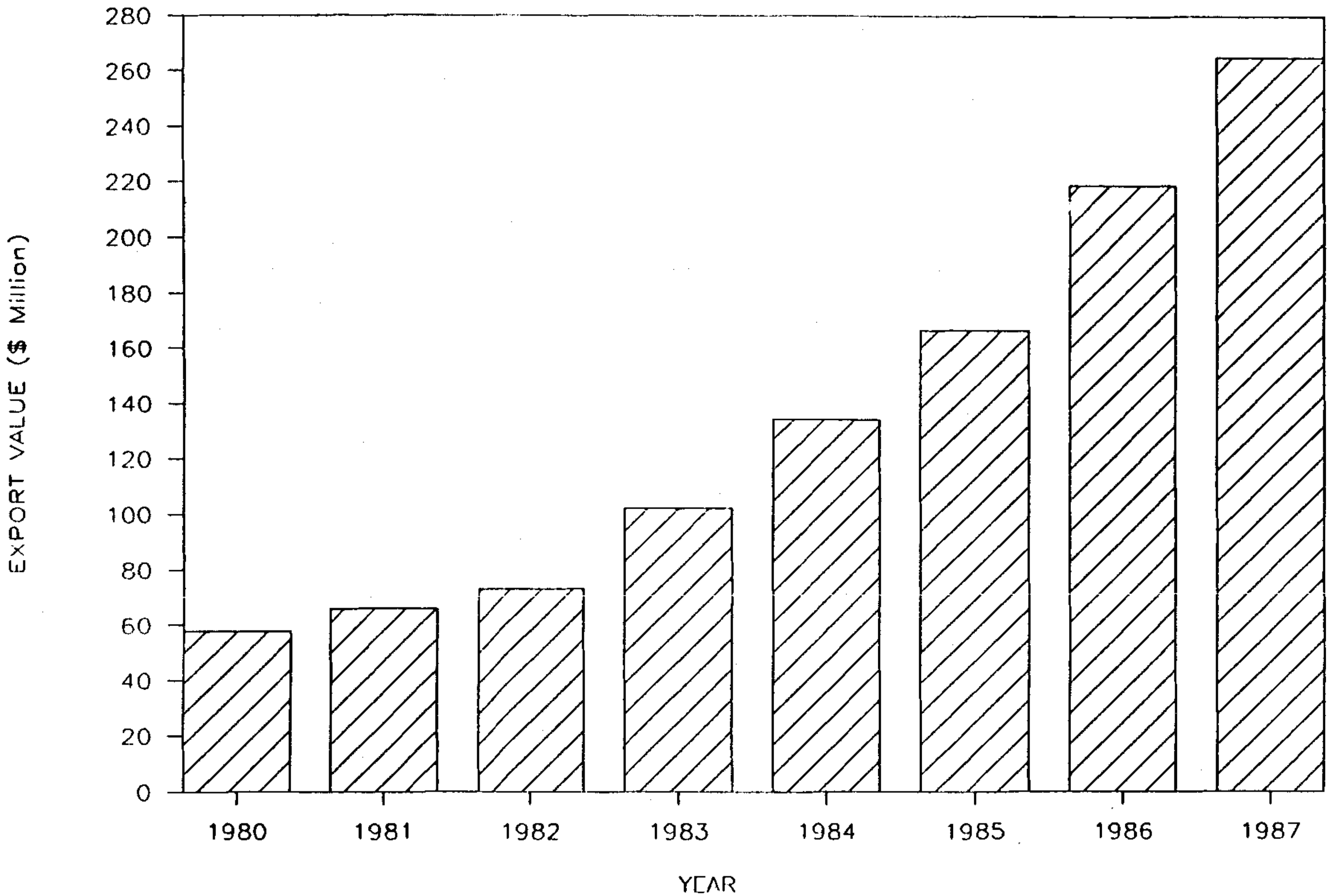
-- International trade. Despite the deterioration of traditional export markets due to worldwide economic trends, the Costa Rican balance of trade has remained stable with the growth of nontraditional exports. In particular, exports of manufactured goods to the United States have grown rapidly (see Figure ii).

-- Fiscal performance. The central Government deficit as a percentage of GDP has decreased slightly and full-time equivalent public employment has increased only slightly.

-- Financial performance. At the domestic level, the private banking sector has grown appreciably, interest rates have been partially deregulated, and financial markets in general have been liberalized. Consumer price inflation, which had exceeded 90 percent in 1982, is now under control (see Figure 1 in main report). At the external level, the Costa Rican balance of payments has been supported by the Cash Transfer program, although long-term independent stability has not been obtained.

-- Employment and equity. At the time of implementation of the Cast Transfer program, Costa Rica's employment rate and social equity were very high, especially by Latin American standards. It is fairly certain that both

Figure ii. Costa Rica: Manufactured Exports to the United States, 1980-1987



would have deteriorated significantly during the economic crisis of the early 1980s without substantial external credits. In fact, available employment and wage indicators have shown an improvement since 1983.

-- Agriculture. The A.I.D. Cash Transfer program has not been directed at the agricultural sector, with the exception of the EARTH project mentioned above. No development impacts are yet evident.

The only reservation the evaluation team had about the long-term development impact of the A.I.D. Cash Transfer program was the possibility of the program creating economic dependency on the part of the Government of Costa Rica or the Costa Rican economy. In fact, the significant growth of nontraditional exports from Costa Rica is evidence of the opposite effect: the economy is developing the means to provide its own balance of payments support. Nevertheless, an external funding source reaching as high as 5 percent of GDP in certain years certainly bears the potential of creating dependency. The prime recommendation of the evaluation team addresses this issue.

Recommendations

The evaluation team developed the following recommendations concerning the design, implementation, and management of the Costa Rica Cash Transfer program.

-- The uses and administration of dollar funds under the Cash Transfer program should be more explicitly confined to the short-term (stabilization) and intermediate-term (structural adjustment) funding for which the program was originally intended. In particular, the Mission should demonstrate that each project and condition involved has a short-term performance indicator and termination date and will not lead to Costa Rica's dependency on Cash Transfer funding. This recommendation does not imply that the structural adjustments encouraged by the program are not themselves long-term changes, but that funding and related conditions should be tranched and related to measurable economic performance results.

-- Timetables for specific economic adjustments should be set more realistically. Even though the ESRs have had 1-year horizons, the individual local currency projects involved could be designed in more realistic 1-year stages rather than projected for full completion in 1 year.

-- USAID/Costa Rica should encourage the formation of competent economic policy analysis offices for both the executive and legislative branches of the Government of Costa Rica.

-- The number of local currency projects for each ESR should be strictly limited (10-15 projects would be a reasonable maximum range), thus allowing the Mission staff to more effectively administer a manageable number of activities.

-- The degree of Mission autonomy in the selection and design of local currency projects should be moderately limited by requiring project-level documentation for larger projects, similar to that required for Development Assistance projects.

-- Interest should be charged on the unexpended balance of the "A.I.D. Special Account" (local currency funds from Cash Transfers), but USAID/Costa Rica should systematically reimburse that interest (using sterilized funds) as the projects involved are implemented.

-- Ideally, the issue of ownership of local currency funds should be left ambiguous as long as possible. However, with the new A.I.D. regulations, ownership and control will have to be assigned to the Government of Costa Rica.

-- If the local currency program becomes too cumbersome or otherwise problematic, it should be discontinued.

The recommendations developed by the evaluation team are presented in more detail in Section 6 of this report, along with a set of conclusions concerning the major issues identified during this study of the Costa Rica Cash Transfer program.

GLOSSARY

A.I.D. - Agency for International Development

CACM - Central American Common Market

CDIE - Center for Development Information and Evaluation of A.I.D.

CINDE - Costa Rican Coalition for Development Initiatives (Coalicion Costarricense de Iniciativas de Desarrolo)

CIP - Commodity Import Program

CNP - National Production Council (Consejo Nacional de Produccion)

CODESA - Costa Rican Development Corporation (Corporacion Costarricense de Desarrollo)

colon - Costa Rican currency (C/)

EARTH - Agricultural School for the Humid Tropics (Escuela Agricola para las Regiones Tropicas Humidas)

ESF - Economic Support Fund

ESR - Economic Stabilization and Recovery Agreement, the basic "contract" for ESF Cash Transfers in Costa Rica

FY - fiscal year

GDP - gross domestic product

GNP - gross national product

IMF - International Monetary Fund

PL 480 - U.S. Public Law 480

SAL - Structural Adjustment Loan, World Bank

SDR - Special Drawing Right, IMF

USAID - A.I.D. country Mission

1. INTRODUCTION

The Cash Transfer component of the Agency for International Development's (A.I.D.) Economic Support Fund (ESF) program has increased considerably over the past decade, both in absolute terms and as a proportion of total A.I.D. funding. Total Cash Transfers amounted to $873 million in fiscal year (FY) 1979, increasing to a projected $2,306 million in FY 1988. The proportion of ESF spending in the total A.I.D. budget rose from 55 percent to 62 percent in the same period, while the proportion of Cash Transfers within the ESF program rose from 45 percent to 64 percent. This funding increase has sparked the interest of Congressional and private assistance groups concerned with the U.S. foreign aid program, an interest that complements A.I.D.'s interest in the effectiveness of the Cash Transfer mechanism as one means among many of fostering economic development abroad.

The present study is the first in a series intended to respond to those interests by evaluating the effectiveness and the economic development impact of the Cash Transfer program on recipient countries. Because of the extensive scope of its ESF program, Costa Rica was chosen as the subject of the first evaluation in this series.

This evaluation presents both descriptive and analytical material relevant to A.I.D.'s Costa Rica Cash Transfer program; it concludes with country-specific recommendations and more general, preliminary "lessons learned." Section 2 describes the multilateral economic policy programs (largely sponsored by the World Bank and the International Monetary Fund [IMF]) operating in Costa Rica in terms of their contribution to the development of Costa Rica's economic policy. The "dollar management" component of the A.I.D. Cash Transfer program, originally considered an adjunct to the multilateral programs, is the subject of Section 3, which includes an initial policy impact analysis. That analysis is continued in Section 4, which addresses the implementation mechanisms of the Cash Transfer program, including local currency generation and the administration of local currency expenditures. The actual economic impacts of the Cash Transfer and multilateral donor programs, as distinct from policy impacts, are the subject of Section 5. Section 6 presents the final recommendations generated by the evaluation of the Costa Rica Cash Transfer program. Finally, material that may be overly detailed for some readers is included in appendixes: Appendix A details the study's methodology, and Appendix B provides a general overview of macroeconomic trends in Costa Rica over the past 2 decades.

1.1 Objectives of the Study

This evaluation is intended to perform the following functions:

- To assess the effectiveness of the Costa Rica Cash Transfer program
- To analyze the economic development impact of that program
- To serve as a model for later Cash Transfer evaluations in this series

The scope of work for this study, jointly designed by A.I.D.'s Center for Development Information and Evaluation (CDIE) and its Bureau for Latin America and Caribbean, is based on these objectives. It specifies the following tasks:

- Examination of macroeconomic trends
- Analysis of the stabilization and structural adjustment policies promoted by international agencies
- Evaluation of A.I.D.'s contribution to the international policy reform agenda via the Cash Transfer system
- Assessment of Cash Transfer design, implementation, and management issues
- Analysis of the economic development effects of the program

1.2 Background of the Cash Transfer Program

The Cash Transfer program is a relatively new element of the A.I.D. funding repertoire, having first reached significant levels in 1978. The development of the program was initially a response to certain worldwide economic needs, but its evolution diverged in individual countries in response to their differing development contexts. The following subsections present a general description of the Cash Transfer system as an element of A.I.D. programming and an explanation of the system that evolved in the Costa Rica program.

1.2.1 Cash Transfers as an Element of Economic Support Fund Programming

The Cash Transfer mechanism is one type of funding within A.I.D.'s ESF program, which also includes Commodity Import Programs and a small number of infrastructure-related projects. In terms of foreign assistance, ESF is complemented by two other A.I.D. programs, Development Assistance and Public Law (PL) 480 food aid programs, which are not subjects of the present evaluation. Each of these programs is designed to address particular development needs, and each economic development context is likely to require a unique mix of programs.

ESF was designed as a flexible assistance tool for promoting economic or political stability in developing countries in which the United States has especially strong security and foreign policy interests. Although ESF programming is most often prompted by political or security considerations (e.g, the Middle East peace process, military base rights, and perceived military threats), to the extent possible, A.I.D. designs the programs to support economic development objectives. These programs include measures to improve a developing country's economic policies, thereby increasing the country's rate of economic growth and improving the distribution of benefits within that country. Policy reform, encouraged by both conditionality programs and local currency expenditures, is an essential part of most programs. In terms of economic development objectives, ESF resources are used most often to address shorter term problems of economic stability. This activity includes balance of payments support through Commodity Import Programs and Cash Transfers to finance general import needs.

In keeping with these policy reform and short-term support objectives, ESF Cash Transfer programs are not considered permanent elements of the A.I.D. portfolio for most countries. This orientation is especially so in the Latin American/Caribbean region, where the problems addressed by Cash Transfers are all short-term and/or political in nature. Although the problems and programs vary by country in this region, Cash Transfer programming is treated as a transitional mechanism by A.I.D., providing a bridge to more specific project assistance or to a complete phaseout of A.I.D. funding.

Thus Cash Transfers, and the ESF program in general, vary considerably from country to country, often because of Congressional directive or because of nondevelopment-oriented U.S. foreign policy concerns. In situations in which economic development is a primary concern of the Cash Transfer program, its implementation depends on the specific development needs of the country involved. The case of Costa Rica is particularly interesting in this regard due to the complex mix of development concerns coexisting with important foreign policy concerns.

1.2.2 Cash Transfers in the Costa Rican Context

The major influences on the design of the Costa Rica Cash Transfer program have been (1) the economic crisis of the early 1980s, (2) A.I.D.'s general Central American development strategy, and (3) U.S. political interests in Central America. Discussion of these three factors follows.

First, during the late 1970s, the terms of trade started to turn against Costa Rica. The price of coffee (the major export crop) fell sharply and petroleum prices doubled. Rather than taking the necessary economic restructuring actions, Costa Rica attempted to maintain its growth performance through heavy internal and external borrowing. Through a policy of strong monetary expansion, Costa Rica was able to maintain existing levels of public and private consumption but at the cost of inflation, overvaluation of the exchange rate, and a reduction of net foreign exchange reserves to negative levels. In July 1981, the Government unilaterally suspended principal and interest payments on its external debt because it could no longer meet the debt servicing requirements. Cut off from external financing, Costa Rica's economy deteriorated rapidly. Gross domestic product (GDP) fell by 9.4 percent between 1980 and 1982. Open unemployment reached 9.5 percent in 1982 and inflation soared above 100 percent.

Second, A.I.D.'s general strategy in Central America is based on the four principal goals enunciated by the National Bipartisan Commission on Central America (the Kissinger Commission): creating economic stabilization, laying the foundation for long-term economic growth, spreading the benefits of that growth, and strengthening democracy. Central to this strategy was the need to maximize the involvement of the private sector in the economic development process, allowing it to take the lead in fostering export-led growth, and to achieve structural change through policy dialogue.

Third, with its strong tradition of democracy and social justice, Costa Rica's success was important to the U.S. goal of encouraging free, stable, democratic nations throughout Latin America. The country's dedication to democracy did not falter in the face of reduced living standards and the growing threat of neighboring Nicaragua. U.S. political interests could be achieved through a process of economic stabilization and sustained, broad-based economic growth.

Given these factors, A.I.D., in conjunction with other international donors and agencies, supported a major stabilization effort accompanied by macroeconomic reforms essential to achieving sustainable long-term growth. The reforms included a major reduction in the number of Costa Rican Government agencies and programs receiving subsidized credit; the creation of a unified, market-based exchange rate; the maintenance of positive real interest rates on both savings and loans; a substantial reduction in the public sector deficit; and the passage of a monetary reform law, which improved the competitive ability of private banks in a state bank-dominated system.

Central to A.I.D.'s strategy was the need to shift the Costa Rican economy from an emphasis on import substitution to one on export-led growth. A.I.D. policy reform efforts focused on removing constraints on private sector investment and exports, particularly new, nontraditional exports. The final elements of the A.I.D. strategy concentrated on equity--the need to ensure that the economic restructuring process also spread the benefits of growth. This equity focus included increasing the involvement of the private sector in areas in which it could be more efficient than the Government, such as increasing employment opportunities or improving housing and educational opportunities.

This evaluation covers the Costa Rica Cash Transfer program from 1982 to 1987. During that period, U.S. economic and financial assistance amounted to $953.1 million, including Development Assistance, PL 480 food aid, and ESF Cash Transfers. Although all elements of the assistance package were designed to support Costa Rica's restructuring effort, ESF Cash Transfers of $730 million represented 75 percent of the assistance package and were the mainstay of the economic policy reform program. The Costa Rica ESF Cash Transfer program consists of the following key elements.

-- The provision of dollar grant funds. The Cash Transfer program has generally been used to permit Costa Rica to finance imports from the United States. Such imports have provided the critical raw materials, spare parts, and capital equipment that have allowed Costa Rica to maintain an adequate rate of economic growth.

-- Policy reform conditionality. Costa Rica, like many other developing countries, has needed to make major policy reforms to restore its economic growth and creditworthiness. It has needed to institute policies to effectively increase productivity, exports, savings, investment, and social services and to curb inappropriate subsidies and inefficient public sector institutions. In general, the Government of Costa Rica has had to design incentives to develop an efficient, market-oriented private sector. In encouraging these policy reforms, the Government has incurred economic and political costs; the Cash Transfers have served to encourage economic reform while helping to buffer its costs.

-- Joint programming of local currency. Cash Transfer dollars "generate"[1] an equivalent amount of local currency, which A.I.D. and the Government of Costa Rica jointly program as part of the ESF agreements. This cooperation has helped ensure that the local currency is used to support the overall objectives of the policy reform program.

All three program elements are consistent with the short-term support typical of ESF programming. The Cash Transfer program in Costa Rica, in fact, is intended not only to be short-term but to lead to an eventual phaseout of the Cash Transfer program in the country.

Many of the elements of the Costa Rica Cash Transfer program are unique and far-reaching, as outlined above and as detailed in Sections 3 and 4. For the evaluation of the program to be comparable to the analyses of Cash Transfer programs in other countries, the methodology for the evaluation of the Costa Rica program must itself be sufficiently broad and far-reaching. The analytical approach described in the following section is designed to be broad enough to address the Costa Rica program as well as other Cash Transfer programs designed under similar circumstances.

[1]Throughout this report, local currency is referred to as being "generated" by the Cash Transfer program or as the "counterpart" equivalent of the dollars provided by A.I.D. These terms are generally used by A.I.D. in its programs worldwide. In Costa Rica, the practice has been slightly different, and the terminology is also different, in that Cash Transfer dollars do not directly generate a local currency counterpart. Instead, the Government of Costa Rica deposits the local currency equivalent of dollar disbursements into the "A.I.D. Special Account." The practical result, however, is the same as in other A.I.D. programs. For the sake of convenience, standard terminology has been followed in this report.

1.3 Methodology

The basic elements of the analytical methodology employed in this study,[2] and intended to be employed in the other studies in this series, are as follows:

-- Policy categories. The covenants, conditions precedent, local currency expenditures, and economic impacts associated with the Cash Transfer program are classified into seven basic policy categories: (1) production and private sector policy, (2) international trade policy, (3) fiscal policy, (4) financial policy, (5) development equity policy, (6) agricultural policy, and (7) other policies. Rather than describing the separate impacts of specific expenditures or items of conditionality, this study examines program impact within this limited and manageable set of categories.

-- Performance indicators. Within each of these policy categories, a limited number (usually one to three) of measures of performance are identified. These indicators are often specified in the Country Action Plan, but are otherwise elements of common usage and concern for the programs involved.

-- Interrelated policy programs. The policy agendas of A.I.D., the World Bank, the IMF, and the Government of Costa Rica are very closely related and on many points are identical. Disentangling the impacts of these separate programs would be impossible both statistically and conceptually in most cases. Where possible, separate impacts of A.I.D.'s Cash Transfer program will be identified, but in general Cash Transfer impacts are not separable from those of complementary stabilization and structural adjustment programs.

-- Dollar transfers versus local currency program. In contrast to other international assistance programs, the A.I.D. Cash Transfer program includes not only transfers of dollar funds, but also a program based on local currencies "generated" by those funds. Thus, program analysis must address the economic development effects of specific types of local currency projects as well as the macroeconomic effects of dollar transfers. The same policy categories described above are employed for both types of analysis.

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[2] See Appendix A for a detailed discussion of the methodology.

-- Public policy versus economic development impact. The public policy of the Government of Costa Rica is likely to change in response to stabilization and structural adjustment programs before visible economic changes occur. Policy change itself is a goal of the programs, but economic development impact is the ultimate objective. However, because economic development impact lags policy change in a variable manner, the former may be difficult to identify and to relate to public policy programs. Therefore, this study attempts to identify and analyze policy change separately from economic development impacts.

-- Treatment of external debt. The external debt problem of developing countries is a worldwide phenomenon not specific to Cash Transfer recipients and thus unlikely to be resolved by the Cash Transfer program. Its existence both before and after Cash Transfers is therefore not considered a reflection on the effectiveness of the program.

-- Perspective on basic economic policy. It is assumed that the general economic policy goals embodied in A.I.D., IMF, and World Bank programs are sound and defensible, and thus no attempt was made to address their fundamental desirability.

2. MULTILATERAL STABILIZATION AND STRUCTURAL ADJUSTMENT PROGRAMS

The two most important multilateral agencies operating in Costa Rica are the IMF and the World Bank. Although the Inter-American Development Bank was formerly quite active in Costa Rica, it has had less impact in the past decade. Its spending is now largely loan-based; continues to be project-oriented; and, with loan repayments mounting, adds little net foreign exchange to the Costa Rican economy. The success of the IMF programs, which have been directed at short-term stabilization and have been based largely on fiscal and balance of payments policy, has varied, depending largely on the performance of Costa Rica's external sector. The Structural Adjustment Loans (SALs) of the World Bank, based as they are on more general economic development criteria, are generally perceived to have been successfully negotiated and implemented.

In contrast to the situation in most developing countries, the A.I.D. Cash Transfer program in Costa Rica has been larger than the IMF and World Bank programs combined. Nevertheless, the conditionality provisions and impacts of the three programs are closely related, and many development impacts are probably jointly due to these programs and Costa Rican Government programs. This section describes and analyzes IMF and World Bank policy programs in Costa Rica, concentrating on the policy dialogue process and identifying policy impacts where possible. The parallel policy analysis of the A.I.D. Cash Transfer program is the subject of Sections 3 and 4.

2.1 International Monetary Fund Stabilization Programs

IMF lending to Costa Rica has had the objective of achieving short-term stabilization, with conditionality provisions directed at public sector growth, fiscal deficits, and balance of payments improvements. Although IMF loans have been small, especially in net terms, and there has been no operative Standby Agreement during most of the Costa Rican adjustment crisis, the effects of IMF conditionality provisions have nevertheless been substantial. This is so because much commercial bank lending and A.I.D. funding have been based on IMF conditionality or covenants "in the spirit" of that conditionality. This section describes the record of IMF activity in Costa Rica and analyzes its policy impact.

2.1.1 The Historical Record

Since early 1980, the Government of Costa Rica has maintained a continual dialogue with the IMF. Five different IMF arrangements have been negotiated, as summarized in Table 1. However, only one of the first four programs negotiated has been successfully completed, and the fifth was approved only recently. In addition, the periods of time during which Costa Rica has been in compliance with an IMF program have been much shorter than the periods of negotiations for new programs. The last two agreements in particular required protracted negotiation.

The first of the series, a 2-year Standby Agreement beginning in March 1980, ended when the Government of Costa Rica failed to meet the first quarterly targets. The economic situation deteriorated badly during the rest of 1980 and early 1981, and a revised 3-year program for Special Drawing Rights (SDR) 277 million was agreed to in June 1981. The seriousness of the Government's intent to carry out this stabilization program was suspect from its start, however, and the Government immediately fell out of compliance. Inflation accelerated sharply to a historically unprecedented 90 percent during 1982, and the economy

Table 1. Chronology of IMF/World Bank Policy-Based Lending to Costa Rica, March 1980-April 1987

Date	Description of Action
March 1980	Two-year IMF Standby Agreement is approved for SDR 60 million. One tranche of SDR 15 million is disbursed before the Government falls badly out of compliance. (Canceled in June 1982, and a new arrangement is negotiated.)
June 1981	Three-year IMF Extended Fund Facility for SDR 277 million is approved. The Government of Costa Rica falls out of compliance by the first quarterly test, and only SDR 22 million are disbursed.
May 1982	Following elections, Luis Alberto Monge succeeds Rodrigo Carazo as President.
December 1982	One-year IMF Standby Agreement is approved for SDR 92 million. Government of Costa Rica meets first three quarterly targets, but fails final two. Final disbursement after extensive renegotiations.
June 1983	World Bank approves $25 million Export Development Loan.
March 1985	One-year IMF Standby Agreement approved for SDR 64 million. First two quarterly targets are met, and SDR 34 million is disbursed, but December targets (during Presidential election campaign) are not met because of Government fiscal performance.
April 1985	World Bank Board approves SAL for $80 million.
September 1985	First $40 million of SAL is disbursed after meeting initial conditions.
May 1986	After elections, Luis Alberto Monge is succeeded by Oscar Arias as President.
June 1986	Second tranche of SAL is disbursed, and World Bank begins work on SAL II.
April 1987	After protracted negotiations, Letter of Intent for SDR 50 million, 18-month Standby Agreement is circulated by IMF staff for Board consideration following completion of Government of Costa Rica/commercial bank negotiations. Board approval is not immediately sought, because the Fund is waiting for an agreement between the Government and the commercial banks. However, because failure to reach such an agreement is not due to Costa Rican Government policy performance, the IMF Board approves the Standby Agreement in October, even without a Costa Rican Government agreement with the commercial banks.

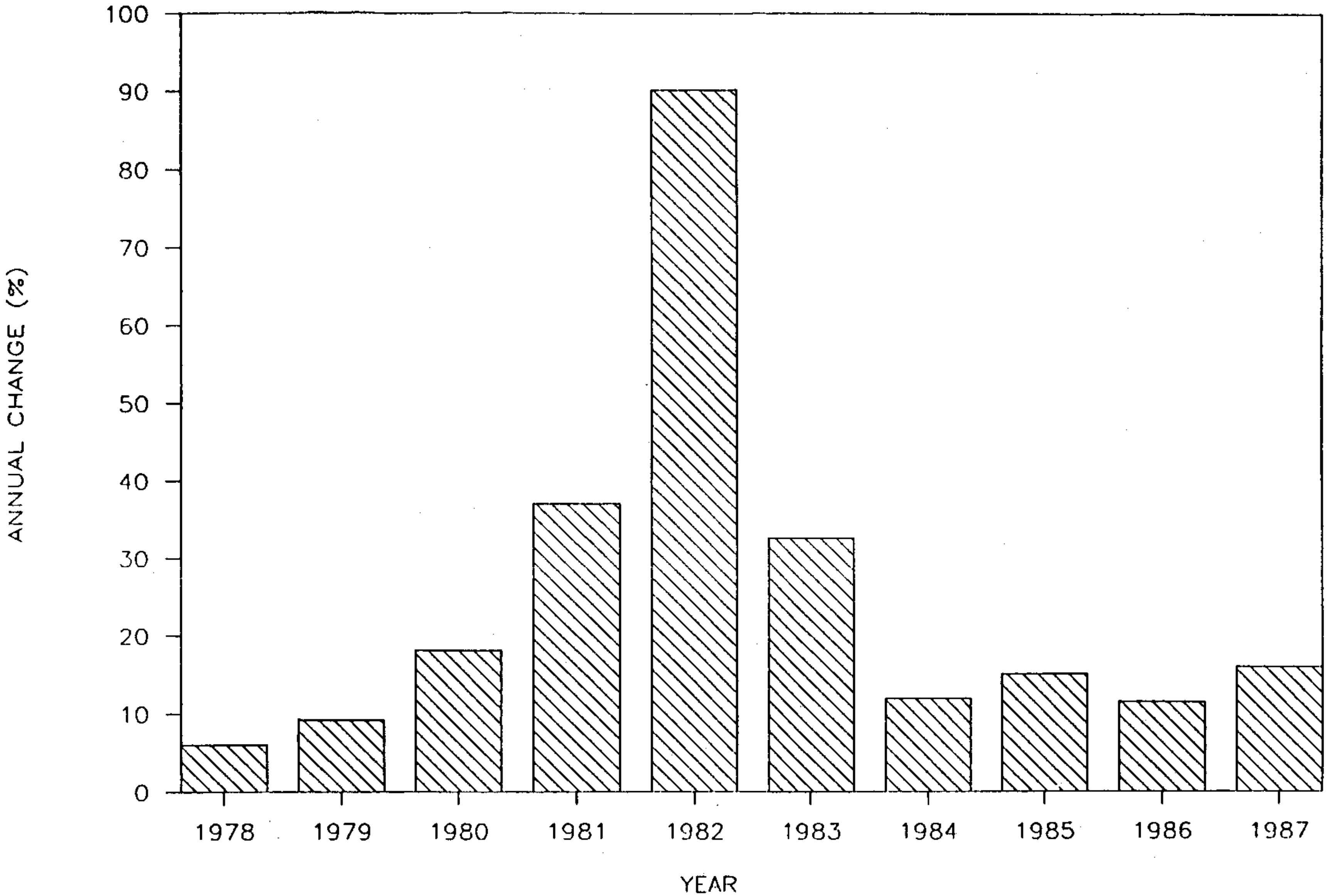
was contracting severely--with a fall of 7.3 percent in GDP in 1982 (see Figure 1), following a decline of 2.2 percent in 1981. Both of these IMF programs must be considered total failures: not only did the Government of Costa Rica immediately fail to meet program targets, but the direction of policy performance was wrong. Basic performance indicators worsened rather than improved.

No A.I.D. balance of payments assistance was provided during this period. The first extraordinary A.I.D. assistance began in FY 1982 with $20 million in Economic Support Fund (ESF) monies. The agreement was signed in July 1982, 2 months after a new government had taken office. About $17 million in Public Law (PL) 480 Title I commodities were also provided in FY 1982, the first Title I assistance in many years.

The new government that took office in May 1982 immediately began to address the critical economic problems facing Costa Rica. A.I.D. had required that the Government obtain an IMF Standby Agreement as a covenant for its FY 1982 assistance. By November of 1982 a new 1-year Standby Agreement had been negotiated, and IMF Board approval was obtained in December. The program involved three main elements: (1) a sharp improvement in the Government's fiscal situation through expenditure cuts, subsidy eliminations, and tax increases; (2) exchange rate unification; and (3) imposition of tight limits on credit creation, particularly to the public sector. The fiscal performance target required reduction in the consolidated public sector deficit from a frightening 14.3 percent of GDP in 1981 to 9.5 percent in 1982 and 4.5 percent in 1983. A.I.D. considered the deficit reduction target "ambitious" and concluded in its May 1983 Project Paper that the agreement would require "an unusual degree of self-discipline and a significant cut-back in living standards for many people, particularly public sector employees" (A.I.D. 1983b).

The IMF Standby Agreement permitted a rescheduling of Costa Rica's foreign debt, for which the country was more than $1 billion in arrears at the end of 1982. A Paris Club rescheduling of official debt was concluded in January 1982, and an agreement with commercial banks was reached in April. While the IMF agreement was being put in place, A.I.D. began large-scale balance of payments assistance. ESF monies of $157 million and PL 480 commodities worth $29 million were provided in FY 1983, with ESF funding linked to compliance with the IMF agreement. The Government of Costa Rica met the first three quarterly targets under the IMF Standby Agreement, but disbursements were suspended in November 1983 over the Government's failure to eliminate a surcharge on foreign exchange purchases. As required by the Standby Agreement, A.I.D. had suspended disbursements several weeks

Figure 1. Costa Rica: Changes in Consumer Price Index, 1978-1987



earlier over a revaluation of the exchange rate. Disbursements in both cases were later resumed after remedial Costa Rican Government action. The full amount of the 1982-1983 Standby Agreement was finally disbursed by December 1983.

As a means of addressing Costa Rica's most critical stabilization problems, the IMF program was extremely successful. The fiscal deficit was held to 9.1 percent in 1982 (versus the 9.5-percent target), and to the 4.5-percent target for 1983. Inflation was dramatically reduced, to below 11 percent by the end of 1983, and a modest economic recovery began. On the external side, however, the rescheduling of Costa Rica's foreign debt provided only a temporary postponement of an unmanageable situation.

The Government of Costa Rica sought a new IMF Standby Agreement at the end of 1983. However, the IMF considered the proposed deficit in the 1984 budget, 15 million colones (₡), to be about three times the level consistent with economic stability and thus refused to negotiate until Costa Rica took remedial action. The Government of Costa Rica obtained legislative approval in February for deficit-reducing measures, and negotiations for a new IMF letter of intent were concluded in March. The IMF required that a series of nine actions be taken, however, before the letter would be submitted for IMF Board approval. About this time, the Central Bank president resigned and was not replaced until August, during which time economic policy drifted. Credit growth was larger than programmed, and imports grew faster than anticipated, resulting in a very rapid but unsustainable economic growth rate of 8.0 percent during 1984. The Government of Costa Rica tightened credit by mid-summer and proposed several additional fiscal measures. The intervening months had made the March letter of intent obsolete, and new negotiations took place in September, with agreement in principle reached in late October.

The IMF Standby Agreement was not formally approved until March 1985. The first two quarterly performance targets were met, and conditions for the third (in September 1985) were met following a waiver by the IMF Board of the condition on external payments arrears. December targets for fiscal performance were exceeded, apparently largely because of politically motivated spending related to the Costa Rican presidential elections of February 1986.

Work on a new IMF Standby Agreement began after the new government took office in May 1986, but uncertainties about Costa Rican Government economic policy--particularly relating to renegotiation of the commercial bank debt--delayed conclusion of a letter of intent until April 1987. IMF management, however, delayed submission of the letter to the Board until the Government of Costa Rica and commercial banks reached agreement on rescheduling of interest payments. When prospects of a relatively prompt agreement dimmed, largely because the commercial banks wanted to reach an agreement with Brazil first, the letter of intent was sent to the Board in October and the Standby Agreement was approved.

2.1.2 Policy Impacts

Fiscal Impact. Table 2 summarizes the trend in overall fiscal deficits of Costa Rica's consolidated nonfinancial public sector. The Government's success in reducing its fiscal deficit from an average of 13.5 percent of GDP in 1980-1981 to an average of less than 2 percent in the 1984-1986 period is impressive. In other IMF programs in the region (e.g., Brazil and Mexico), the failure to make sustained progress on fiscal deficits has been the major factor in the failure of stabilization efforts. Appendix Table B-11 shows that a combination of increased public revenues and expenditure restraint made the deficit reduction possible in Costa Rica. Overall, the share of the public sector in GDP declined modestly from its peak in the 1978-1980 period, while revenues rose substantially.

Table 2. Consolidated Nonfinancial Public Sector Deficit, Costa Rica, 1978-1987

Year	Overall Deficit (₡[a] billion)	Current GDP (₡ billion)	Deficit/GDP Ratio (percent)
1978	2,713	30,194	9.0
1979	4,222	34,584	12.2
1980	5,502	41,405	13.3
1981	7,807	57,103	13.7
1982	8,475	97,505	8.7
1983	4,603	129,314	3.6
1984	3,089	163,011	1.9
1985	3,715	192,425	1.9
1986	3,684	239,231	1.5
1987	1,900	272,858	0.7

[a]₡ = colon(es), Costa Rica's currency.

Balance of Payments Impact. The record of the IMF programs in reestablishing external accounts stability has not matched that of reestablishing acceptable fiscal performance. The early IMF Standby Agreements assumed that Costa Rica's exports would recover significantly faster than they have, because commodity prices were expected to recover more than they actually have. Moreover, the assumptions regarding private capital flows and ability to service debt appear decidedly optimistic in retrospect. The programs appear to have unrealistically treated postponement of debt service for a few years into the future as a solution to Costa Rica's debt-service problem.

The requirement in IMF programs for elimination of arrears on external payments is a particularly difficult issue. Because the major arrears problem has been that of debt service to commercial banks, this requirement puts the IMF in the role of bill collector for commercial banks. With the reduction in arrears a formal requirement of the Standby Agreements, IMF resources are explicitly linked to payment of the commercial bank debt. Moreover, the linkage may limit Government incentives to improve balance of payments performance. A dollar improvement in the balance of payments simply means another dollar paid for commercial debt service--an implicit tax of 100 percent on balance of payments improvement. Clearly, IMF involvement in the negotiations between the Government of Costa Rica and the commercial banks is a complicating factor and one that may reduce the willingness of the commercial banks to negotiate reductions in debt payments. Nevertheless, this issue relates to the overall Latin American debt problem--and the international response to it--and not just to the Costa Rican case.

2.1.3 Other Issues

Several observations arise from a review of IMF programs over the 1982-1986 period. First, IMF conditionality provisions generally appear to have been consistent with those of A.I.D. and to have exerted a positive impact on the stabilization of Costa Rica's economy.

Second, and somewhat surprisingly, the heavy emphasis of IMF conditionality provisions, and the principal factor in long delays between Standby Agreements, appears to have been the fiscal accounts. Disputes between the Government of Costa Rica and the IMF over the level of the fiscal deficit appear to have been the principal stumbling block to effecting these agreements, while the adequacy of the exchange rate played a far less significant role. Given the Government's impressive performance in reducing its fiscal deficit, this continuing emphasis seems curious.

Third, the level of net IMF support to Costa Rica over the 1982-1986 period (IMF fiscal years) was quite small. Net of repurchases, IMF provided only SDR 58.8 million over this period. Charges on Costa Rica's outstanding obligations to the IMF totaled SDR 55.2 million, so the net cash flow to Costa Rica from the IMF was only SDR 3.6 million during the 1982-1986 period. Of far greater importance, of course, was the impact of the IMF Standby Agreements on other external obligations. IMF programs were a precondition to Paris Club rescheduling of official debt and to earlier commercial bank reschedulings, so they contributed substantially to postponement of repayments on other debt.

2.2 World Bank Structural Adjustment Programs

World Bank lending to Costa Rica has had the objective of promoting export-led growth via structural adjustment and economic policy reforms, with conditionality focusing on reforming trade policy, controlling public sector growth and deficits, and improving external debt management. World Bank loans have been larger than funding under IMF Standby Agreements (SAL I was for $80 million), but are still small in comparison to the A.I.D. Cash Transfer program, which reached nearly $800 million in 6 years (through FY 1987). Nevertheless, the World Bank program has been quite effective in Costa Rica due to the extent to which conditionality provisions are coordinated with other international donors and the Government of Costa Rica.

Table 3 outlines the record of World Bank structural adjustment lending activity in Costa Rica from the initial Costa Rican Government requests in 1981 through the deliberations over SAL II. Compared with the record of IMF lending, World Bank activity in Costa Rica has progressed smoothly.

3. A.I.D. CONTRIBUTION TO STABILIZATION AND STRUCTURAL ADJUSTMENT PROGRAMS

The A.I.D. Cash Transfer program consists of both direct dollar transfers and a local currency program. Direct dollar transfers are quite similar to the IMF and World Bank programs in that they are denominated in dollars, used essentially as balance of payments support, and conditioned on fairly direct policy guidelines and covenants, known collectively as "conditionality."

This section of the evaluation report describes the operation of the direct dollar transfer component of the Cash Transfer program in Costa Rica. It begins with a statistical profile of the dollar transfers and related conditionality and then describes actual operations. Following that description, the conditionality of the A.I.D. dollar transfer system is compared with that of other international donor programs, and the extent to which Costa Rican Government policy has conformed to that conditionality is assessed. Finally, the policy results of A.I.D.'s Cash Transfer program in Costa Rica are compared with alternative A.I.D. programs (i.e., project assistance and Commodity Import Programs).

Table 3. Progress of World Bank Policy-Based Lending in Costa Rica, 1981-1987

Date	Description of Action
1981	Initial SAL request by Government of Costa Rica
1982	Renewal of request, following change of government
June 1983	Initiation of basic preparation for SAL I
January-June 1984	World Bank Pre-Appraisal Analysis
July, September 1984	Appraisal Missions
October, December 1984	Post-Appraisal Missions
February 1985	Final Negotiations with Government of Costa Rica
April 1985	Final World Bank Board Approval
September 1985	Release of First Tranche of SAL I
June 1986	Release of Second Tranche of SAL I
September 1987	Negotiation Mission for SAL II

3.1 Statistical Profile

Prior to 1982, U.S. assistance to Costa Rica was relatively modest, totaling only $13 million in 1981. In 1982, it jumped to $51 million and then increased to $212 million in 1983. Although Development Assistance spending remained modest, additional Economic Support Fund (ESF) and Public Law (PL) 480 funds were obligated to help stabilize an economic situation that had been rapidly deteriorating since the late 1970s. A.I.D. is currently in the sixth year of an ESF Cash Transfer program for Costa Rica. This section discusses the levels of this support relative to both the total U.S. assistance program and the Costa Rican economy. It then provides a brief statistical sketch of the policy orientation of the program.

Figure 2 shows the levels of A.I.D. assistance to Costa Rica from 1978 to 1988, illustrating how Cash Transfers have become dominant in both relative and absolute terms. During the 1970s, total U.S. assistance to Costa Rica averaged only $9 million per year. With the 1982 Cash Transfer of $20 million, total assistance increased by nearly four times. Cash Transfers have since dominated the U.S. aid program to Costa Rica, reaching 74 percent of total funding in 1983 and 83 percent in 1987.

ESF Cash Transfers have also been large relative to Costa Rica's population and economy. Costa Rica is a small country, about the size of West Virginia, with a population of 2.7 million. From 1982 to 1987, per capita Cash Transfer obligations averaged $55, compared to an average per capita GDP of $1,493 for that period (Table 4). During this period, ESF obligations have averaged 3.8 percent of GNP, reaching as high as 5 percent in 1983.

A major objective of Cash Transfers is to provide the recipient with foreign exchange to purchase critical imports needed for productive purposes. Since 1983, Cash Transfer resources have provided an average of 12.8 percent of the foreign exchange needed for Costa Rica's imports. Table 4 provides insight on the foreign exchange requirements of Costa Rica through statistics on foreign trade and debt service obligations, including the reserve-to-import ratio. This measure indicates that Costa Rica would have a maximum buffer of 5 months during which it could finance imports out of current reserves if all reserves were liquid. The reserve-to-import ratio has improved significantly during the 1980s--from 10 percent in 1980 to 45 percent in recent years. However, a large proportion of these reserves are not liquid, representing claims on nations of the Central American Common Market (CACM) which may not be collectible or, at best, may be converted to long-term obligations. Costa Rica's import cushion is therefore somewhat less than 5 months, depending on the actual degree of liquidity of CACM obligations.

Interest payments on outstanding debt to foreigners is another important use of foreign currency. The final two statistics in Table 4 show the percentage of Costa Rican exports needed to cover its debt service (35-55 percent, even after rescheduling), and ESF Cash Transfers as a percentage of debt service

Figure 2. U.S. Economic Assistance to Costa Rica, 1978-1988

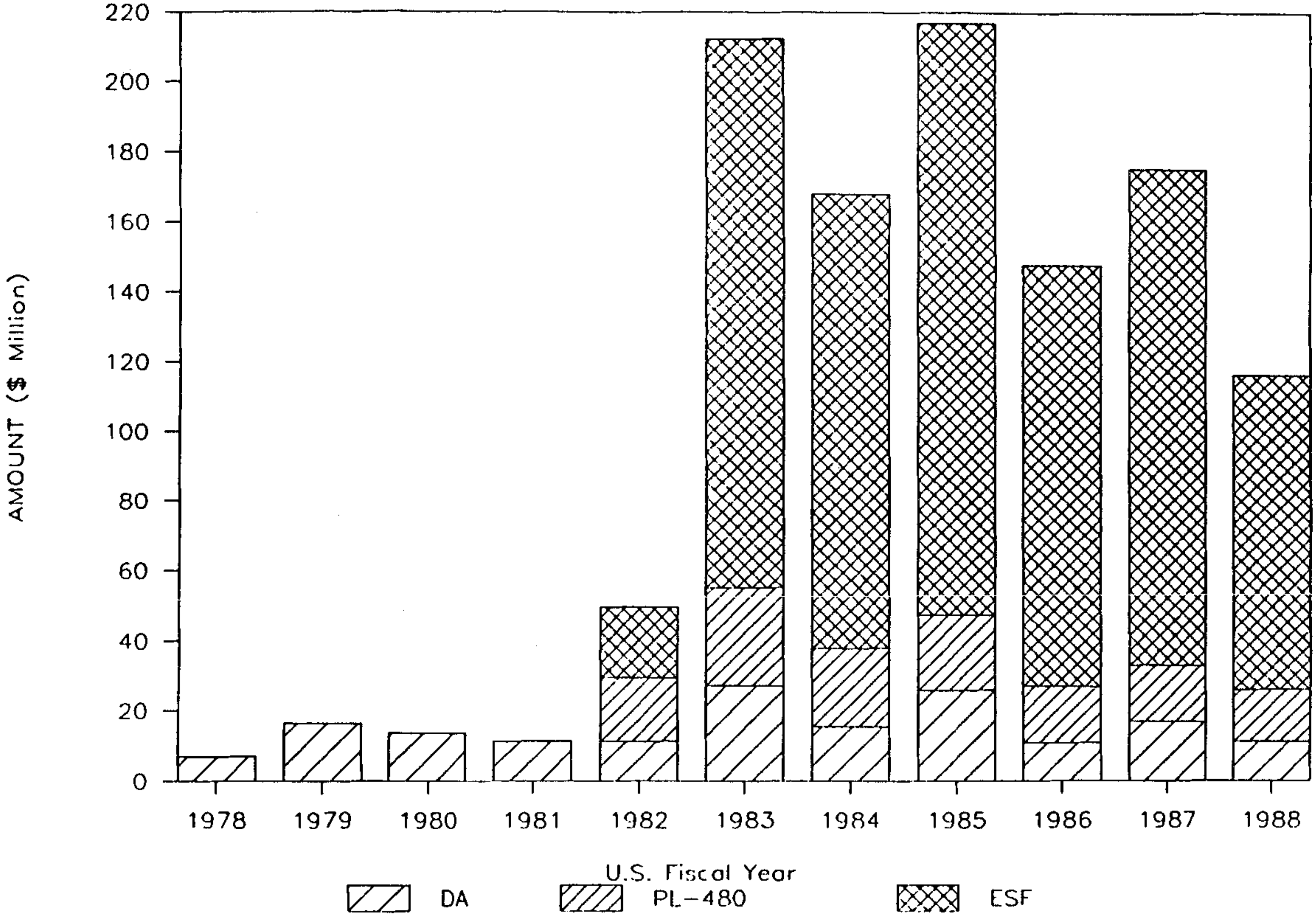


Table 4. A Comparison of Costa Rican Foreign Trade and Debt Service Obligations With Economic Support Fund Cash Transfers, 1982-1987

Item	1982	1983	1984	1985	1986	1987	Average (1983-1987)
ESF (million $)	20	157	130	160	120.6	142.4	142
Per Capita ESF ($)	8	64	52	62	46	53	55
Per Capita GDP ($)	1,099	1,292	1,464	1,485	1,620	1,604	1,493
ESF as Percent of GDP	0.8	5.0	3.6	4.2	2.8	3.3	3.8
ESF as Percent of Imports	2.2	15.8	11.8	14.4	10.4	11.8	12.8
Reserves/Imports (percent)	25.3	31.3	36.8	45.6	45.0		
Debt Service/Exports (percent)	54.4	36.2	40.9	34.5	45.1		
ESF as Percent of Debt Service[a]	4.2	50.3	31.9	49.9	24.8		

[a]All debt services data are after rescheduling.

payments (as high as 50 percent). Evidently, the ESF program in Costa Rica is significant not only in terms of relative size but also in terms of meeting Costa Rica's need for foreign exchange.

How do dollar transfers to Costa Rica relate to the policy objectives of the Cash Transfer program? Table 5 shows the number of covenants attached to A.I.D. dollar transfers by policy category. Nearly half the covenants are in the financial sector, with 33 of the total of 105 covenants relating to Central Bank of Costa Rica credit allocations and ceilings. The covenants either increase or maintain credit levels available to private sector enterprises by specifying dollar equivalent credit amounts for private credit lines or the Central Bank's credit program. Some of the credit-related covenants deal with reporting requirements to A.I.D. or exclude specific entities from receiving credit to cover subsidy losses. Completing the financial sector category are nine covenants on interest rate levels and three covenants relating to the implementation of the Price Checking Unit established to prevent capital flight from Costa Rica.

There have been 21 Economic Stabilization and Recovery Agreement (ESR) covenants supporting international trade performance, approximately equally divided between the objectives of (1) allocation of foreign exchange to the private sector in the amount of ESR resources, (2) progress toward foreign exchange unification, and (3) the encouragement of exports through various promotion efforts.

Another important group of covenants, 15 in total, established target dates for divestiture of the Costa Rican Development Corporation (CODESA) interests in specifically named public sector enterprises. ESRs II-V each had a covenant directing credit to low-income housing. An additional covenant under ESR III required municipal water and sewage systems to be constructed or improved in order to supplement credit to the housing sector.

Other covenants, 16 in total, are administrative in nature. They direct local currency deposits to particular accounts or specify which reports are to be provided to A.I.D. Of the 16 covenants, 4 are related to providing A.I.D. with copies of reports sent to the IMF. One covenant under ESR II required that Costa Rica negotiate and implement an IMF Standby Agreement.

3.2 The Process of Dollar Transfers

The administration of dollar transfers, as opposed to that of the local currency program, is a fairly straightforward process, although it has recently undergone some modification. The

Table 5. Economic Stabilization and Recovery Agreement Policy Covenants for Costa Rica, by Policy Category
(number of covenants)

Policy Category	ESR I	ESR II	ESR III	ESR IV	ESR V	Total
Production and Private Sector Development			3	6	7	16
Price Structure			1			1
CODESA Divestiture			2	6	7	15
International Trade Performance		5	8	3	5	21
Foreign Exchange Availability		2	2	2	2	8
Exchange Rate		1	1	1	2	5
Export Promotion		2	5		1	8
Fiscal Sector		10	15	8	12	45
International Capital Flows			1	1	1	3
Central Bank Credit Availability		10	9	5	9	33
Interest Rates		5	2	2	2	9
Employment and Equity Housing		1	2	1	1	5
Other		6	4	2	5	17
Infrastructure			1			1
IMF Related		2		1	2	5
Administrative Requirements		4	3	1	3	11
Total	0	22	32	21	30	105

process begins with USAID/Costa Rica, which continuously analyzes Costa Rica's resource needs and development constraints. Through regular meetings with private sector representatives and Government of Costa Rica planning, finance, and operating ministries, the Mission and the Government develop a series of measures to address development problems. The Government then sends USAID/Costa Rica a letter requesting Cash Transfer assistance, stating its intention to implement a series of policy reforms. The Mission, with reference to the Country Development Strategy Statement, then develops its Annual Action Plan and budget submission, incorporating the policy reforms to be included in the annual Cash Transfer program, the prospective local currency program, and recommended budget levels.

After Congressional approval, A.I.D. reviews and approves a Program Assistance Approval Document that has been prepared by USAID/Costa Rica. This document is the Cash Transfer commitment document that authorizes (1) the level of funding; (2) the purpose and uses of the dollar funds; (3) policy reform conditions, covenants, and special provisions; and (4) local currency uses. The Mission then negotiates with the Government of Costa Rica to reach final agreement on the provisions to be included in the Project Agreement. The signing of the Project Agreement by the Government of Costa Rica and the United States represents the formal obligation of A.I.D. ESF dollar funds to the Cash Transfer program.

The Program Assistance Approval Document and Project Agreement contain a dollar disbursement schedule linked to specific performance conditions and criteria, allowing A.I.D. to disburse funds in tranches in response to specific Costa Rican Government actions on policy reforms. A typical Cash Transfer might have two or three separate disbursements. When the Government of Costa Rica satisfies the conditions for a disbursement, USAID/Costa Rica notifies A.I.D. and requests a dollar disbursement. A.I.D. then notifies the U.S. Treasury to transfer the dollar funds to the Costa Rican Government's U.S. bank account. For ESRs I through V, the funds went into the Costa Rican Government's general bank account. After dollar disbursements were made, the Government provided evidence that eligible commodity imports from the United States were at least equal to ESR disbursements. The level of U.S. imports was thus determined on a post facto attribution basis rather than on a detailed, transaction-by-transaction basis.

The procedure changed with ESR VI, which requires the Government of Costa Rica to place the Cash Transfer dollars in a separate account to avoid commingling ESF funds with other Costa Rican Government monies. This procedure enables a separate accounting and identification of uses. ESR VI also ended the import attribution procedure, replacing it with a requirement for documentation that confirms that the required level of imports was actually achieved.

3.3 A.I.D. Conditionality and Policy Dialogue

One objective of A.I.D.'s Cash Transfer program in Costa Rica, as expressed in the relevant Program Assistance Approval Documents and Country Development Strategy Statements, is the development within the Government of Costa Rica of a policy analysis capability. This objective is distinct from that of imposing specific policies on the nation's government. Although the covenants and conditions precedent of the various ESRs are expressed in terms of conditions to be met by the Government of Costa Rica prior to disbursement of funds by A.I.D., the policy program is mutually designed by the Government of Costa Rica, A.I.D., and other international agencies. This section describes A.I.D. conditionality in the context of an ongoing policy dialogue, contrasting it to World Bank and IMF conditionality and highlighting Costa Rican Government policy reforms.

3.3.1 Comparison With IMF and World Bank Conditionality

Before the Kemp-Kasten Act of 1984 prohibited the conditioning of U.S. foreign assistance solely on compliance with agreements with multilateral donors, Cash Transfers were conditioned on IMF Standby Agreements. Thus, in the first several years of the Cash Transfer program, IMF and A.I.D. conditionality could not be entirely separated. In years when an IMF Standby Agreement was not in place, A.I.D. conditionality provisions were consistent with the conditions of the proposed IMF letter of intent. Furthermore, according to A.I.D. officials, the Costa Rican Government's record of compliance continued to closely follow the spirit of IMF conditionality during the absence of a Standby Agreement.

Although A.I.D., IMF, and World Bank conditionality provisions for Costa Rica were mutually supportive, each organization stressed a different part of the aid package. The IMF emphasized monetary factors (money supply and credit), fiscal policy (Government taxes, expenditures, and deficits), and the foreign exchange rate, whereas the World Bank emphasized economic restructuring (export promotion and investment). Although A.I.D. included many of the same IMF and World Bank conditions, it emphasized public sector divestiture, private sector development, banking reform (including banking privatization), and export promotion.

3.3.2 Record of Compliance

The Costa Rican Government's overall record of compliance with the conditions and covenants of the Cash Transfer program has been good, in part because USAID/Costa Rica has been flexible enough to modify conditionality provisions as changes in economic conditions have made it necessary. The Government's performance is now closely monitored using a computerized system, which reports that the great majority of conditions have been satisfied. More important, the highest priority conditions, including the unification and correct valuation of the exchange rate, promotion of private sector banking, maintenance of positive real interest rates, and divestiture of public sector entities, have been met and maintained. The relatively few cases of noncompliance center mainly on a failure to meet deadlines or to provide reports. For example, meeting conditionality deadlines of divestiture for CODESA public sector enterprises is still a problem.

Some conditions have been modified because they were impractical or unfeasible; in most cases, the Government has complied with the modified conditions. For example, ESR III included major conditionality provisions on credit and interest rates, limiting credit allocation to a maximum of three subsidized rates as opposed to five, as in previous years. As a result, the Government of Costa Rica reduced the number of credit limits to 23, as opposed to some 53 subclassifications in 1983. By February 1985, there were only three broad categories: allocation of subsidized credit, productive activities, and unproductive activities (i.e., commerce, utilities, personal credit). With these exceptions, detailed credit allocations have been substantially eliminated.

Following is an analysis of Costa Rican Government policy reforms by policy category as related to A.I.D. Cash Transfer conditionality provisions.

Private sector development. The A.I.D. ESF program is supporting the transfer of ownership of some major budget-draining state enterprises from CODESA (a state-owned holding company) to the private sector. Major subsidiaries of CODESA are being sold, dissolved, or liquidated. They include ALUNASA, an aluminum plant, recently acquired by the private sector; CATSA, a sugar refinery to be transferred to a cooperative in March 1988; and 40 percent of CEMPASA, a cement plant, which has been put up for bid. This divestiture is expected to be concluded by June

1988. The Government is also examining ways to cut public sector employment by transferring some activities and services to cooperatives formed by employees currently performing these services.

The Costa Rican Coalition for Development Initiatives (CINDE), a private sector industrial promotion agency, was created by ESR I. It has been quite successful in promoting new investment and exports. In terms of public sector policy dialogue, however, this organization has not been able to accomplish much.

Price subsidies for rice, corn, beans, and sorghum account for about 10 percent of the value of agricultural production. These subsidies led to rice production in excess of domestic market demand.[3] Basic grains were sold at prices below cost, and large financial losses incurred by the National Production Council, the state marketing agency, were funded by the Central Bank. Price supports still exist for numerous crops, and they generally favor large-scale farmers.[4] Public authorities still control the market prices of many agricultural and industrial commodities.

In general, the liberalization of the Costa Rican economy and the promotion of private sector activities on the part of the Government of Costa Rica are due largely to its policy dialogue with A.I.D.

International trade. In October 1983, the Central Bank unified the exchange rate and implemented a crawling peg system, with the degree of devaluation derived from a formula relating rates of inflation in Costa Rica to those of its major trading partners. From December 31, 1984 through September 25, 1987, the colon was devalued 59 times and the exchange rate increased by 50 percent from 43.65 to 65.35 colones to the dollar. The official exchange rate remains fixed at 20.0 colones to the dollar, but it is used only for a tiny fraction of all foreign exchange transactions. This policy reform was made after extensive dialogue with A.I.D. and World Bank representatives.

A reduction of nominal import tariffs in January 1986 brought down the average tariff to 65 percent, with effective protection ranging from 50 to 150 percent. Continued reduction of import tariffs is currently under negotiation for the World Bank Structural Adjustment Loan (SAL) II. Efforts are being made

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[3]Removal of rice from the National Production Council was a major step toward removing subsidies.

[4]Public sector expenditures in agriculture indicate a sharp rise in relation to GDP, from 4 percent in 1975 to 22 percent in 1985. Subsidies make up a substantial portion of the rise.

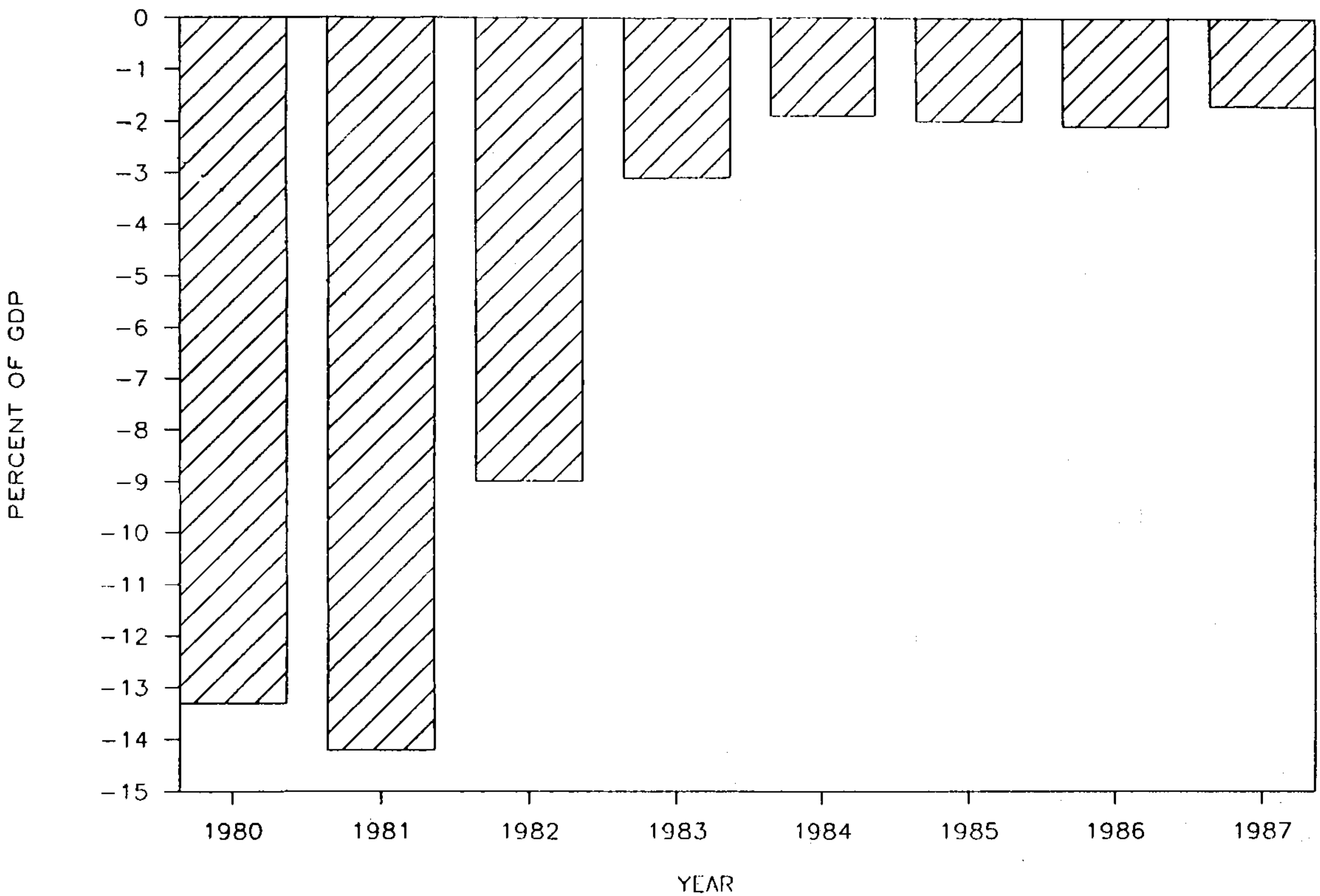
to lower nominal tariffs to a 40-percent average and the effective rate of protection to a 75-percent average, over a 3-year period. Costa Rica is currently negotiating to become a full member of the General Agreement on Tariffs and Trade (GATT).

In addition, Costa Rica is actively working to expand nontraditional exports to markets outside the CACM. Special policy changes include establishment of an "export contract" under which the investor receives an agreed-on set of incentives, including negotiable tax credits, exoneration from income tax, and exemptions from import duties and some taxes on locally purchased inputs. Costa Rica, under a condition of the current Cash Transfer agreement, is reclassifying its tradables to be consistent with the Brussels nomenclature in order to open its nontraditional exports to more world markets. It has also set up a price-checking unit to prevent overinvoicing of imports and underinvoicing of exports.

Fiscal reform. The major element of A.I.D. Cash Transfer conditionality aimed at progressively reducing public sector deficits has been achieved: the deficit as a proportion of GDP has steadily dropped over the past 5 years (see Figure 3). The Government of Costa Rica has reduced the total public sector deficit from 14.6 percent of GDP in 1981 to 5.3 percent in 1986. Excluding Central Bank losses, the public sector deficit stood at only 1.5 percent of GDP in 1986. This reduction represents a major accomplishment toward achieving economic stability. The IMF's efforts to curtail the growth of public sector employment, with its high wages, have not been as successful, however. In other areas, A.I.D.-led efforts toward the privatization of CODESA represent a continued effort to curtail the drain of nonfinancial public institutions. While the CODESA scheduling deadlines have often not been met (probably because of unrealistic scheduling), divestitures are taking place.

Monetary policy and financial market reform. Since 1984, the Central Bank has been liberalizing the financial system. Nonmarket credit allocation (e.g., credit ceilings and allocative credit categories) has been replaced with more market-oriented mechanisms (e.g., changes in reserve requirements on bank deposits, open market operations, and, most important, positive market-determined interest rates). Private and Government-owned banks are now free to allocate credit and set interest rates on most deposits and loans. Some credit (less than 15 percent of the total) is still allocated by Government-owned banks at subsidized rates, with the requirement that the highest rate charged on loans cannot exceed the lowest rate by more than 8 percentage points. Limits are being placed on expanding subsidized credit.

Figure 3. Costa Rica: Consolidated Nonfinancial Public Sector Deficit, 1980-1987
(as percent of GDP)



The availability of funds to private sector banks has enhanced competition among Government-owned and private banks, and there is a movement to make the system more competitive by expanding the types of financial instruments that the private banks can issue. USAID/Costa Rica has also supported passage of Costa Rican legislation authorizing the creation of the National Housing Mortgage Bank.

Employment, equity, and basic needs reform. Public policy toward employment, equity, and basic human needs has not been addressed directly by the A.I.D. Cash Transfer program, although the actual economic trends affected by the program certainly have produced improvements in those areas (see Section 5 and Appendix B).

3.4 Policy Dialogue

The preceding discussion indicates that A.I.D., as a part of a joint international organization/Government of Costa Rica effort, has made substantial positive impact on Costa Rican economic policies. Comparison of IMF, World Bank, and A.I.D. covenants and conditions indicates a coherent and comprehensive policy reform process aimed at correcting Costa Rica's unstable economic structure, but implemented in such a way as to minimize the adjustment costs. The Government of Costa Rica has been a full partner in this process at the level of policy dialogue. Generally, A.I.D. has encouraged and enabled policy reform that the Government of Costa Rica wanted to implement but lacked the international reserves and/or political will to accomplish.

The process of policy dialogue now needs to be developed further. From 1982 to 1987, the analysis of the impact of prospective policy reforms has been carried out primarily by A.I.D., the IMF, and the World Bank. With the possible exception of the Central Bank, the Government of Costa Rica's analytical role has been limited. In the case of A.I.D., policy reform conditionality provisions have often been developed with only limited analytical input from discussion in the key ministries (with the exception of the Central Bank). USAID/Costa Rica regularly consults members of Costa Rica's legislative branch on policy conditionality, and genuine policy dialogue has been developed between these parties. Yet the analytical resources of the legislature, as well as those of executive branch ministries, are extremely weak. The Government of Costa Rica needs to build more capacity for planning and policy analysis by developing a multiyear approach that delineates how key policies will change over time.

The Office of the President, in particular, would benefit by increased policy analysis capability. At present, there is no equivalent of a "Council of Economic Advisors," nor is there a well-developed staff capacity at the executive level. The president must depend on his cabinet officers for economic advice, a source not unencumbered by ministerial bias.

3.5 Alternative A.I.D. Programs

Although the Cash Transfer program appears to have worked well in Costa Rica, an effective evaluation should address the two relevant alternatives--project assistance and Commodity Import Programs (CIPs).

3.5.1 Project Assistance Approach

A.I.D. project assistance focuses on key problems that constrain a country's development. For example, livestock disease or the lack of trained manpower. The usual solution is implementation of a project that provides expert advisers, training, and commodities within a strengthened institutional setting (e.g., a veterinary project or a training school). However, the project approach has not been judged suitable for A.I.D.'s Costa Rican program: the country's level of development is relatively high, most of its institutions are functioning effectively, and its economy is relatively small. Under these conditions, it might be difficult to justify a yearly, project-targeted ESF funding level of a significant size. If A.I.D. wants to provide a large transfer of resources, another funding alternative is required.

3.5.2 Commodity Import Program Approach

A CIP provides funding for the import of U.S. commodities. It can generate local currency and serve as the basis for policy dialogue. When compared with a Cash Transfer, a CIP has both advantages and disadvantages in the Costa Rican context:

Advantages

1. CIP funds are tied to U.S. procurement. The benefits to the U.S. economy and balance of payments are clear. In contrast, Cash Transfers are free foreign exchange. They can be used for U.S. imports, imports from other countries, debt service, or to build up reserves. With

a Cash Transfer it is hard to show a direct benefit to U.S. taxpayers and U.S. businessmen. With a CIP it is easy to track uses and benefits (to both U.S. and Costa Rican interests).

2. CIP funds are subject to financial controls. Competitive bidding is required to ensure a fair price. Diversion of funds to foreign bank accounts is almost impossible.

3. Commodity eligibility can be carefully screened to ensure that only the most critical products are imported. Targeting of both commodities and users is possible.

Disadvantages

1. The main drawback is the time required to disburse CIP funds. A CIP involves detailed paperwork, and regulations must be satisfied. It usually takes a minimum of 18 months, and often up to 3 years, to fully disburse a CIP. If the main objective is rapid foreign exchange availability, a Cash Transfer is much more efficient.

2. Because CIP dollars are disbursed at a slower pace, local currency generation is also slower. If a local currency-funded project needs to be implemented quickly, a CIP is not as effective as a Cash Transfer.

3. A CIP provides the Government of Costa Rica with a less flexible resource, because it usually cannot be used to pay for oil imports, debt service, or urgently needed imports from non-U.S. sources.

4. Because CIPs are tied to U.S. procurement, the Government of Costa Rica might find that it has to import goods that are higher priced or not as appropriate as imports from other countries.

5. A.I.D. regulations and 50/50 U.S. shipping requirements add to the cost of CIP imports. When compared with a Cash Transfer, the Government of Costa Rica may end up paying more for CIP imports.

6. From the perspective of the Government of Costa Rica, a Cash Transfer is a more valuable resource; thus, it may be more difficult for A.I.D. to negotiate policy reforms when providing a less valued CIP.

In summary, a CIP provides a clear benefit to U.S. exporters and helps A.I.D. promote the program to Congress. It also provides financial control and accountability. However, because Costa Rica has a market-determined foreign exchange rate and capital flight is not a great problem, the need for control and supervision of funds is not as great as with other A.I.D. recipients. The key factors in choosing between a Cash Transfer and a CIP are the size of the program and the need to make rapid disbursements. If the aid program continues to be large in relation to Costa Rica's economy, and if rapid disbursements are important, then a Cash Transfer is the better form of aid.

4. IMPLEMENTATION MECHANISMS FOR LOCAL CURRENCY PROGRAMS

Although transfers of dollar funds--with their associated covenants and conditions precedent--are an effective means of addressing balance of payments problems and economic policy, the expenditure of local currency generated by those dollars may have more immediate effects. This section analyzes the Costa Rican local currency program, as distinct from the transfer of dollar funds. It begins with a statistical profile of local currency expenditures by policy category, moves on to an administrative description of the program, and concludes with a policy analysis of program implementation issues.

4.1 Statistical Profile of Local Currency Expenditures

As of September 30, 1987 Costa Rica's local currency Special Account had received ₡19.3 billion. Table 6 breaks down the obligations of those funds, organized according to the seven policy categories presented in Section 1.3, which are similar to the categories included in A.I.D.'s policy reform agenda. The major expenditure area was "Production and Private Sector," including factors that directly increased output. This category received the bulk of local currency funding--42 percent of the program. Major components of this expenditure area included the divestiture of the Costa Rican Development Corporation's (CODESA) public sector enterprises (36 percent) and investment/export promotion by the Costa Rican Coalition for Development Initiatives (CINDE) (7 percent).

"Agriculture" was the next major category, with 30 percent of local currency expenditures, consisting primarily of funding for the Agricultural School for the Humid Topics (EARTH) (24 percent). "Employment and Equity" was next in level of funding,

Table 6. Summary of Local Currency Obligations for Economic Stabilization and Recovery Programs I-V, by Agreement and Policy Category (thousands of colones)

Policy Category	ESR I	ESR II	ESR III	ESR IV	ESR V	Total	Percent
Production and Private Sector	223,500	750,959	104,516	7,101,117		8,180,092	42.28
International Trade Performance		130,360	194,994	146,214	143,358	614,926	3.18
Fiscal Sector		1,327	944			2,271	0.01
Financial Sector			155,385		1,114,000	1,269,385	6.56
Employment and Equity		624,226	719,830	117,931	278,500	1,740,487	9.00
Housing		251,546	522,282	30,000	278,500	1,082,328	5.59
Education		310,540	197,548	87,931		596,019	3.08
Health		62,140				62,140	0.32
Agriculture		17,582	3,760,000	6,200	1,937,610	5,721,392	29.57
Other		276,565	653,398	705,502	184,069	1,819,534	9.40
Total	223,500	1,801,019	5,589,067	8,076,964	3,657,537	19,348,087	100.00
Selected Institutions Included in Totals Above							
CODESA				7,034,793		7,034,793	36.36
EARTH			2,760,000		1,885,600	4,645,600	24.01
CINDE	223,500	787,747	133,609	236,939	168,332	1,450,127	7.49
							67.86

funding, with 9 percent of expenditures, including housing, education, health, and other social services. Other policy reform categories received only minor funding.

An examination of Action Plans and annual Economic Stabilization and Recovery Agreement (ESR) Program Assistance Approval Documents shows that all seven policy reform categories were analyzed and justified in great detail. The Cash Transfer program objectives included several areas similar to the policy categories used in this evaluation, including economic growth, improved incentives for the private sector, privatization, export promotion, equity and employment, investment promotion, interest rate reform, banking reform, and agricultural development. Although all of these were areas of expenditure, Costa Rica's local currency program emphasized one policy target--increased production. Within that target, the bulk of funding went for CODESA's divestiture program.

The CODESA divestiture program was important because it (1) put a stop to open-ended Costa Rican Government subsidies to money-losing state enterprises, (2) reduced the public sector deficit, and (3) turned assets over to more efficient private sector firms. Its prominence in terms of expenditure is surprising in that the original Cash Transfer program documentation did not describe a 5-year strategy so heavily based on one institution.

A similar concern arising from this statistical overview is the major support (24 percent of local currency funds) provided to the EARTH endowment. As is noted in Section 5, the funding for EARTH yielded a low rate of return; further, there were major questions about the small number of graduates EARTH was producing, and doubts about whether its curriculum and technology deserved such a major investment. In other words, the large endowment to EARTH could be excessive in relation to actual benefits produced. (These issues are treated in more detail in Section 5.)

4.2 Local Currency Generation

In each of the six iterations of the Costa Rica ESF Cash Transfer program, an equivalent amount of local currency has been placed in the Special Account and programmed for development activities (see Table 6 for program details). The local currency has been provided by the Government of Costa Rica at the highest exchange rate in effect when the dollars were disbursed.[5] From that point onward, the management, administration, and monitoring of local currency projects have varied, depending on project size. As shown below, however, these procedures have conformed closely to A.I.D. guidelines.

4.2.1 Management Approach

A.I.D.'s worldwide ESF program includes a variety of local currency management approaches. Some are completely autonomous at the local level, while others allow for direct control by the USAID Mission. At one extreme are programs in which counterpart funds are "attributed" to general sectoral and budget categories. In such a case, A.I.D. does not fund individual projects and thus there is no need to become involved in detailed project selection or monitoring. At the other extreme are countries in which individual projects are directly funded, with A.I.D. engineers and technicians monitoring the actual construction and operation of such projects as schools, grain storage, and agricultural facilities.

The Costa Rican program was not intended to be an autonomous budget attribution program, but was instead to be based on direct Mission control and management. Although Costa Rica's program is project-based, however, not all of its projects are intensively managed. The size and complexity of the individual project activity has determined the degree of A.I.D. involvement in monitoring and supervising the project. The more important and complicated projects have received close Mission supervision, whereas most of the others have received only limited Mission attention.

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[5] During this period, the Government of Costa Rica has periodically devalued the colon/dollar exchange rate to reflect the market value of the colon. The exchange rates in effect during this period varied from ₡20 = $1 in 1982 to ₡64 = $1 in 1987. Because the colones have been generated at different exchange rates, it is difficult to assign a dollar value to individual local currency projects. In addition, unexpended funds in the Special Account have earned interest at market rates averaging near 20 percent, which increases the colon value of the Special Account. Thus, it is best to think of the local currency program in terms of colones, rather than dollars.

4.2.2 Administrative Approach

Administration of the Costa Rican local currency program has included several steps, with some variation from agreement to agreement. In general, the first step is the preparation of the annual Mission Action Plan, including proposed local currency expenditures and their relationship to the overall program strategy. After A.I.D. approval of the Action Plan and notification of funding availability, the Cash Transfer Project Agreement is negotiated with the Government of Costa Rica. These negotiations produce a list of broad sectoral programs and some specific subprojects. Some agreements are quite specific about which activities would be funded, whereas others set only general areas of emphasis. After the Cash Transfer Project Agreement is approved, project proposals are identified and developed by the Mission staff based on their relation to the Country Development Strategy Statement/Action Plan. Project approach and design are then discussed with individual ministries and operating organizations.

The next step is the preparation of a Mission Local Currency Activity Justification Document for each project. For larger, more important projects, this document is comprehensive and very similar to an A.I.D. Project Paper. For most projects under Costa Rica's local currency program, however, it is relatively short--only two to three pages. The document covers most of the following topics: project description and background, relationship to Mission strategy and to other A.I.D. activities, a description of project objectives and activities, relative implementation priority, beneficiary impact, implementing institutions, timing and financial plan, implementation plan, disbursement mechanisms, payment provisions, and monitoring/reporting requirements. The Activity Justification Document is then reviewed and approved by the Mission director.

The next step is the preparation of a Memorandum of Understanding, including a budget, statement of project objectives, and an implementation plan. The Memorandum is designed to be much like a regular A.I.D. Project Agreement, prepared by the Mission and sent to the Costa Rican implementing agency. The implementing agency co-signs the Memorandum of Understanding, indicating that it agrees to the provisions. A.I.D. then sends a Project Implementation Letter to the Central Bank of Costa Rica, which co-signs this letter and disburses funds from the Special Account to the account of the organization implementing the project. Only at that point does local currency become monetized and project operations begin. USAID Mission staff periodically make on-site visits and monitor project operations and progress over the life of the project.

4.2.3 Project Selection

Local currency uses have been selected by the Government and USAID/Costa Rica in two ways: (1) by using the Cash Transfer Project Agreement to identify, in detail, the individual activities; or (2) by identifying in the Project Agreement the general areas in which the local currency would be used, leaving specific identification of activities until a later stage. The Mission has used local currency as a major resource to support its development strategy, negotiating with the Government of Costa Rica to reach agreement on activities consistent with that strategy. Negotiations on macro-level activities were handled by the USAID director, economist, and program officer. Other USAID offices assisted in the identification and negotiation of the more technical projects in the agricultural, housing, education, and private sectors.

Most of Costa Rica's local currency programs have supported major structural changes essential to the Mission's policy reform agenda. Thus, as much Mission management and staff time was spent on policy dialogue leading to agreement on project selection as was spent on actual project implementation. For example, reaching agreement on the CODESA divestiture and establishment of the National Housing Mortgage Bank projects involved months of discussions to ensure that the policy principles underpinning these activities remained intact through the negotiations leading to agreement on the design and implementation plans. Such activities often required a lengthy Costa Rican Government legislative process, which necessitated Mission involvement in tracking progress and ensuring that key principles were included in the final legislation. Such was the case with Legislative Assembly consideration of the Mortgage Bank and the agricultural school (EARTH).

4.2.4 Project Implementation and Monitoring

For each project, the Memorandum of Understanding establishes agreement among all parties on how the project is to be operated. Negotiations on the Memorandum specify project objectives, responsibilities, and financial plans. When final agreement is reached, the Mission issues a Memorandum of Understanding, which "obligates" local currency funds. Actual operations and implementation are usually carried out by the cooperating Costa Rican institution. Mission personnel are not involved in the daily operations of the project. Because the project activities are important to achievement of Mission program objectives, however, the Mission may closely monitor project operations.

There has been a Mission project manager assigned to each of the 30 to 50 projects that are active at any one time. Larger and more important projects receive intensive management, with a number of Mission offices involved, including top management.

Project managers are responsible for ensuring that their projects are on track, that funds are being spent in a timely and appropriate manner, and that A.I.D. objectives are being met. Every 1-2 months the project manager visits the implementing agency's office to review project financial and operating data, later visiting the project site to assess operations by reviewing published reports and meeting with those familiar with project operations.

The Mission's financial management system tracks local currency funds available, disbursements, and progress toward meeting project timetables and objectives. The system is designed with the Memorandum of Understanding as the central accounting point, with the Controller's Office maintaining detailed financial records on the obligations and disbursements for each Memorandum. The system was computerized and used daily by the Mission program office, project development office, and controller's office.

The Mission's local currency approach has required heavy Mission involvement in all facets of the program. During the negotiations of ESRs, perhaps half of Mission staff time has been devoted to local currency policy planning, activity selection, negotiations, project monitoring, and financial control.

4.3 Implementation Issues

The Costa Rican local currency program has been creatively designed and imaginatively implemented. Nevertheless, any program of this size will invariably generate controversies, and questions will arise concerning its implementation. Both the U.S. General Accounting Office (GAO) and the A.I.D. Regional Inspector General have audited the USAID/Costa Rica Cash Transfer program, and some of the issues raised in those audits have economic and administrative ramifications that should be addressed in this report. This section addresses the following issues concerning the implementation of the Costa Rican local currency program:

- Ownership of local currency funds
- Appropriate latitude of Mission discretion in the expenditure of local currency

-- Scope of local currency activities

-- Payment of interest by the Central Bank on the A.I.D. Special Account

-- Necessity of a local currency program

USAID/Costa Rica's experience with these issues may well have application beyond Costa Rica.

4.3.1 Local Currency Ownership

A review of the Program Assistance Approval Document for ESRs I through V does not clearly establish whether the Government of Costa Rica or A.I.D. owns the local currency funds. However, these documents speak of the "A.I.D. Special Account," the "A.I.D. Special Line of Credit," and A.I.D.'s need to audit and account for its funds. The terminology used by the Central Bank and other Costa Rican Government agencies also relates these funds to A.I.D. rather than to Costa Rica.

In addition to the terminology used, management procedures have also implied that these were A.I.D. funds. Although the Project Agreements discuss joint programming of these funds by the Government of Costa Rica and A.I.D., actual operations allowed for direct monitoring and control by USAID/Costa Rica. Although the Government reviewed most project proposals and funding uses, the funds were not included in the Costa Rican Government's budget process and were not scrutinized by the legislature. All local currency uses were treated by the Government of Costa Rica as "extra-budgetary" expenditures, and in practice, A.I.D. had almost complete control of local currency funds. This procedure is in sharp contrast to the normal Costa Rican practice of heavy legislative involvement and close ministerial control of all expenditures.

This question of local currency ownership and responsibility was raised by the A.I.D. Regional Inspector General in a September 1987 draft Audit Report. The draft stated that the Mission unilaterally controlled and managed Costa Rica's local currency program, although the funds were not an A.I.D. resource. It further noted that there was little oversight or input from the Government of Costa Rica, and that USAID/Costa Rica had failed to provide the Government of Costa Rica with all local currency Memorandums of Understanding, Project Implementation Letters, and other financial reports. The draft report posed the question of who was ultimately responsible for the program.

The question of ownership and responsibility clearly bothered and confused the Inspector General auditors. In one section of their draft, they found that the Mission controlled and managed local currency funds without letting the Government of Costa Rica have a say in the use of those funds. However, in another section of the audit it was noted that the Mission had not effectively managed the implementation of several projects, for which construction and operation were slow and some outputs were not achieved. Thus, the audit argued both sides of the question: the Mission was in error for managing the Costa Rican Government's local currency and the Mission was not effectively managing A.I.D.'s local currency. In the same report, local currency was implied to be both the Costa Rican Government's money and A.I.D.'s money.

This issue may soon be resolved. The 1987 ESR VI Program Assistance Approval Document states that local currency funds will be treated as a Costa Rican Government-owned resource, a statement missing from earlier Program Assistance Approval Documents. With ESR VI, the Mission moves from direct control to a more collaborative approach. USAID/Costa Rica plans to start the transition in 1987 by having the Government of Costa Rica participate more actively in project selection and management and by having it review and sign all Memorandums of Understanding. Present plans are for the 1988 agreement to treat local currency funds as Costa Rican Government-owned resources, with the Government having primary responsibility for budgetary approval and accountability. Although this change in procedure will relieve A.I.D. from bearing the major responsibility for the effective use of the local currency funds, the Mission will lose much of its ability to manage and program what has been a very flexible resource.

Defining local currency funds as the property of the Government of Costa Rica would also resolve a related issue raised by the draft Inspector General audit--that of fiduciary responsibility. It could be argued that USAID/Costa Rica has made itself legally liable for local currency projects by controlling their selection and monitoring.

If the ownership issue is decided as described above, the evaluation team recommends that USAID/Costa Rica work out procedures with the Government of Costa Rica to ensure that project activities are selected promptly and monitored properly and that unexpended funds do not accumulate. The Mission and the Government of Costa Rica will need to ensure the following conditions.

-- Early and firm identification of activities

-- A timely system for ensuring ministry and legislative approval

-- A Costa Rican Government financial system to effectively track obligations and disbursements

-- An auditing system to ensure financial integrity and program compliance

Nevertheless, the evaluation team concludes on economic and administrative grounds that the "constructive ambiguity" of the current local currency program in Costa Rica has had positive effects. The Mission has been able to employ local currency in a creative and effective manner, with the full (if informal) participation of the Government of Costa Rica. If legal changes restrict this arrangement in the future, the Cash Transfer local currency program will not be nearly as effective as it has been.

4.3.2 Mission Latitude in the Use of Local Currency Funds

Access by USAID Missions to Cash Transfer-generated local currency funds amounts to prospective project expenditure without full project-level regulation. Although neither this evaluation team nor (to our knowledge) the Inspector General and GAO auditing teams have found evidence of misuse of this discretion, A.I.D. should consider whether large local currency expenditures should be subjected to the same set of procedures and guidelines as are Development Assistance expenditures. At the very least, such low return projects as the EARTH school (see Section 5.6) might receive more scrutiny in that case.

4.3.3 Scope of Local Currency Activities

Another implementation issue of considerable importance is the scope of Costa Rica's local currency program in terms of the number of projects funded. At the time of this evaluation, the five ESF agreements had supported nearly 120 individual activities. Although ESR I had only one activity, ESR II included 45 separate projects, ESR III had 38, ESR IV had 22, and ESR V had 10. CODESA, CINDE, and EARTH represented two-thirds of local currency funding. The remaining one-third of funding supported over 100 activities. Some of those 100 activities were large, but many were only in the $10,000-$50,000 range. The design, management, and monitoring burden of dealing with so many small activities can be enormous. A review of Mission files shows that the problems addressed and the paperwork required for a small activity are often equal to those of much larger projects. In addition, there is a question of program focus. A tighter, more focused set of activities would strengthen the impact of the local currency program.

As compared with earlier programs, ESR IV and ESR V had fewer small projects. From evaluation team discussions with the Mission, it is clear that they are aware of the problem and intend to place some limits on program dispersion. The evaluation team recommends that the number of projects be limited, with their minimum size increased and sectoral selection more concentrated. This change would allow Mission staff the time needed to analyze and deal effectively with a few key issues and would also allow more effective project monitoring and supervision. Costa Rica's local currency program has proven that projects based on thorough analysis, backed by substantial funding, can have a major developmental impact. The distraction of dealing with a large portfolio of small projects does not seem to be an effective use of scarce Mission staff time.

4.3.4 Interest Payments on Local Currency Funds

Beginning with ESR IV, USAID/Costa Rica has required the Central Bank to pay interest on the balance of the A.I.D. Special Account. Although this requirement provides an incentive to use the funds for their intended purpose in a more timely manner, it also causes significant resentment on the part of Costa Rican Government officials. Such a payment adds to the deficit of the Central Bank, which is counter to the policy objectives of the Cash Transfer system itself. ESR V included a provision that the interest payment could be reversed or "sterilized" by a balancing local currency payment once Cash Transfer conditionality had been met.

The incentive effects of interest payments are undeniable, and such payments may soon become worldwide A.I.D. policy. Because of the negative effects mentioned above, however, the evaluation team recommends that USAID/Costa Rica consider full reimbursement of interest payments on the Special Account each year. Such a system would have the advantage of providing incentives to spend local currency funds, because without expenditure, conditionality would not be met and interest would not be reimbursed. At the same time, the system would avoid expanding the Central Bank deficit.

4.3.5 Is Local Currency Programming Necessary?

Given the above-mentioned problems with Cash Transfer local currency programs, combined with prospective additional problems once funds are defined as host country property, many observers have suggested that the program may not be so necessary after all. The following observations bear on that possibility.

A.I.D. policy regulations state that Commodity Import Programs and most Cash Transfers must generate local currency funds. By means of these funds, A.I.D. can affect the host government's budget process to promote key projects and sectors. Because local currency uses affect investment and productivity, they may be as important to the economy as the Cash Transfer dollars.

Although local currency programs are an integral part of A.I.D.'s Costa Rica program, the other two organizations providing balance of payments and restructuring assistance to the country do not use local currency programs (World Bank Structural Adjustment Loans and IMF drawings). Their perspective is that constructive investment and restructuring can be achieved when Costa Rica takes appropriate policy actions, obviating the need to create local currency and monitor its use. The inconvenience of generating and then spending counterpart funds is not necessary if the host government agrees to appropriate conditions and covenants when it receives assistance.

The evaluation team does not entirely agree with this perspective. In terms of practical operations, the Costa Rica local currency program has proven to be an efficient way to direct local resources in support of policy reform objectives for the following reasons: (1) local currency is a flexible resource; (2) the local currency program has been insulated from local budgetary pressures; and (3) while it is possible to gain agreement on policy initiatives, Government agencies operate on funding, which provides incentive for action. These issues are discussed in more detail in the following paragraphs.

A flexible resource can respond to changing needs. The Cash Transfer program was a multiyear effort implemented in annual increments, with each year's program tailored to meet slightly different objectives. The FY 1982 and FY 1983 programs (ESRs I and II) concentrated on investment and export promotion through CINDE. The FY 1984 program (ESR III) focused on the agricultural school, EARTH. The FY 1985 program (ESR IV) was centered on the divestiture of CODESA's state-owned enterprises. The FY 1986 program (ESR V) focused on EARTH and a special private sector line of credit. The ability to shift emphasis, while maintaining the overall objectives, was clearly useful. It allowed A.I.D. to focus sequentially on different facets of the restructuring effort.

An additive, extrabudgetary resource provides insulation from political pressure. The Government of Costa Rica has viewed the local currency as an additional resource falling outside of the Government's normal budgetary process and has treated the funds as A.I.D.'s resource, separate and distinct from the Government's own revenues. Costa Rica has a strong legislature, which is actively involved in the domestic budget process. Political concerns and "pork barrel" interests are a natural result of such a democratic system. The need for political consensus may doom high-cost efforts requiring legislative action and attempting to restructure and remove long-run development constraints. In addition, as in most countries, Costa Rica's budget was heavily committed to ongoing, recurrent Government services and programs. Local currency funds were outside of this system and were used to support such restructuring reforms.

Funding provides incentive for change. Economists and top policymakers understand the importance of economic restructuring and are usually willing to initiate donor-supported programs. However, conditions may change. A bad crop or a decrease in export earnings can demolish a country's policy reform program; if domestic revenues are not at the level anticipated, it is difficult to continue with reforms. However, if a separate fund is available to support those efforts, they may continue. In effect, that is what the Costa Rica local currency program has done: although all initiatives were not up to expectations, the availability of a separate account helped to ensure that resources were available to support most of the planned initiatives. Costa Rican Government budget shortfalls forced a cutback in many programs. Although many Government programs were reduced or deferred, local currency-supported programs did not suffer as seriously. In that sense the local currency program insulated many activities.

A final benefit of "using money as the medium for change" can be seen in addressing complex problems requiring changes in laws and regulations. The CODESA divestiture is a prime example of such a case. In addition to the political difficulty of convincing the legislature of the need for privatization, there were mechanical problems concerning the Costa Rican constitutional prohibition against selling an enterprise at less than full book value. Many CODESA enterprises included assets that were grossly overvalued, and annual losses had been included as assets in the capital base. A firm with a book value of $10 million might be worth only about $5 million to private investors. By using $5 million of local currency funds to buy down the book value, a firm could then be sold to private entrepreneurs. To achieve rapid implementation of policy reform, it was easier to use local currency funds to effect change rather than to change the laws.

Other international agencies (especially the IMF) have questioned whether A.I.D.'s local currency programs are consistent with economic stabilization objectives. Is it possible that Cash Transfer-generated local currency represents excess credit creation, leading to renewed inflationary pressure? The evaluation team's answer to this query, at least for the case of Costa Rica, is a qualified "no." Creation of local currency under the Costa Rica Cash Transfer program has been limited to parameters agreed upon by the IMF, A.I.D., and the Government of Costa Rica. Excess local currency has been "sterilized"--that is, removed from effective circulation in the Costa Rican economy. As long as sterilization continues, local currency programs will not cause inflationary pressure in Costa Rica.

Local currency programming is to a certain extent interventionist. One might argue that a nation should have complete control over its own budget. In that case, however, international policy programs in general are suspect. In summary, the team was impressed with the practical benefits achieved with the Costa Rican local currency program and does not consider it to have violated local prerogatives. The World Bank and the IMF, in contrast, have operated without a local currency program and have had difficulty implementing their reforms.

5. ECONOMIC DEVELOPMENT EFFECTS OF STRUCTURAL ADJUSTMENT PROGRAMS AND POLICIES

This evaluation report distinguishes between the policy impacts and the economic development impacts of the policy reform programs. Although this distinction is often difficult to maintain, earlier sections of this report have addressed primarily the policy impacts of the A.I.D., World Bank, and IMF programs under analysis. This section presents the evaluation team's analysis of the economic development impacts on the Costa Rican economy of the stabilization and structural adjustment programs of these three agencies, concentrating on the A.I.D. Cash Transfer program when possible. Even though some of the policy initiatives involved have not yet had time to show results, many of them have, and a fairly clear evaluation of the economic development impacts of the programs is possible.

5.1 Production and Private Sector Performance

Private sector development has been one of the major objectives of the Costa Rica Cash Transfer program, both at the level of conditionality requirements for dollar transfers and at the level of expenditures of local currency. The program has been fairly successful in promoting this goal in three major ways.

-- The Costa Rican Coalition for Development Initiatives (CINDE) has emerged as an effective, private sector-controlled promoter of investment in Costa Rica.

-- The divestiture of the national holding company, the Costa Rican Development Corporation (CODESA), has finally moved beyond the planning stage, with the sale of ALUNASA (an aluminum milling company) and preliminary negotiations on several other transactions.

-- Costa Rican economic growth and production have largely recovered from the economic crisis of the early 1980s, although factors in addition to policy reform have aided in this reversal.

Other Cash Transfer program-influenced impacts on the Costa Rican private sector, including the development of private banking and promotion of nontraditional exports, are addressed in later subsections.

5.2 International Trade

5.2.1 Exports

Because of the normal lag time between policy change and production, particularly in manufacturing, it is too soon to identify changing trade patterns as a result of Costa Rican Government policy reform, with the notable exceptions of growth in nontraditional exports and expansion of maquila (drawback) activities. Total export performance has been stable, with the decline in exports to the Central American Common Market being offset by increasing levels of nontraditional exports to other markets.

The impact of the Cash Transfer program on overall exports since 1985 has been positive in terms of maintaining a real effective unified exchange rate at or near its true level.

Exports would probably have been lower if the colon had been overvalued.

5.2.2 Nontraditional Exports

The major observable impact from policy changes promoting exports in general has been the rise in levels of nontraditional exports. Appendix B (especially Table B-3) details the trends of these exports.

The strong performance of Costa Rica's nontraditional exports in recent years is in part explained by the improvements in exchange-rate management. Exports of these products rose from $167 million in 1982 to an estimated $390 million in 1987, surpassing coffee exports in the latter year. Should this rapid growth continue for the next several years, a major structural change will have taken place in Costa Rican exports. Projections indicate that nontraditional exports would reach 50 percent of total exports in 1993, compared with 36 percent in 1987 and 19 percent in 1982. To maintain this growth path, the Government of Costa Rica will need to continue to improve the policy framework for export promotion.

5.2.3 Imports

The Cash Transfer program has affected Costa Rican imports through its effect on exchange rates, import restrictions, and export promotion. Imports would have been higher had Cash Transfer program conditionality provisions not encouraged Costa Rica to maintain the colon at roughly its correct value. At the same time, efforts to promote nontraditional exports have actually raised imports because production of nontraditional exports is more import-intensive than production of traditional exports. Lowering trade restrictions, insofar as these efforts have been successful, has also increased imports to Costa Rica.

5.2.4 Trade Balance

A disappointment of the Costa Rica Cash Transfer program is the continuing balance of trade deficit, despite the economy's successful recovery through balance of payments support, structural adjustment assistance, and improvements in the terms of trade. The resulting external debt has created a short-term dependency on A.I.D. and other donors. Financial assistance prevents the disequilibrium of the external markets from creating another financial crisis and resulting recession.

In conclusion, the recent growth of nontraditional exports has had some influence in reducing the trade deficit. Imports, however, continue to exceed exports. Costa Rican Government policies all appear to be moving in the right direction, but they have not yet been able to stabilize the balance of trade.

5.3 Fiscal Performance

From the beginning of the Cash Transfer program, A.I.D. placed a high priority on reducing Costa Rica's fiscal deficit. Economic Stabilization and Recovery Agreement (ESR) I in FY 1982 contained a covenant under which the Government of Costa Rica agreed to negotiate an IMF Standby Agreement, which typically has targets and ceilings related to fiscal performance. In ESR II for FY 1983, IMF Board approval and signature of the Standby Agreement constituted a condition precedent to the second and subsequent disbursements. ESR II also contained a special provision stating that "A.I.D. reserves the right to suspend scheduled monthly disbursements in the event that the Government of Costa Rica is not in substantial compliance with the IMF Agreement as determined by A.I.D." This special provision was in fact invoked in 1983, with both IMF and A.I.D. suspending disbursements. Disbursements were resumed after the Government of Costa Rica took corrective action.

A main feature of the IMF Standby Agreement signed in December 1982 was a performance target calling for a reduction in the consolidated public sector deficit from 14.3 percent of GDP in 1981 (subsequent revisions put the figure at 13.7 percent) to 9.5 percent in 1982 and 4.5 percent in 1983. Data presented in Appendix B show that the Government of Costa Rica met this target of a 10-percentage-point reduction over a period of only 2 years. This significant achievement was due mainly to improvements in the operations of the decentralized agencies and Government enterprises, particularly through rate increases by the electricity company and the petroleum refinery and a sharp increase in payroll charges by the Social Security Institute.

In seeking to assign credit for achievement of the 1982-1983 fiscal targets, it is of course difficult to isolate the effects of A.I.D. conditionality provisions from those of IMF conditionality provisions and the Costa Rican Government's own determination to stabilize its economy. Nevertheless, it is reasonable to assume that A.I.D. conditionality provisions--and the external resources associated with them--played a role in reducing the public sector deficit.

After these encouraging developments in 1982 and 1983, economic policy performance deteriorated in 1984. The Government of Costa Rica and the IMF failed to concur on a hoped-for new Standby Agreement, mainly because the 1984 budget established in late 1983 appeared to imply an overall fiscal deficit of ₡15 billion, or about 9 percent of GDP. The lack of an agreement between the Government of Costa Rica and the IMF delayed the signing of A.I.D.'s ESR III program. Although the loan portion of the agreement was signed in May 1984, the grant portion was not signed until August. Covenants under ESR III included a limit on banking system credit to CODESA, the deficit-plagued state-enterprise holding company, and to the National Production Council, the heavily subsidized state agricultural marketing entity. Another covenant called for addressing the CODESA problem over the long run through development of a plan for divestiture/privatization of CODESA's holdings.

During the course of 1984, the Government modified the highly expansionary fiscal and monetary policies with which it began the year and which resulted in a real GDP growth rate of 8.0 percent (as well as a sizable balance of payments deficit). The Central Bank began to tighten liquidity in July of that year; new revenue measures were enacted; planned capital expenditures were reduced; and another attempt was made, under a new Central Bank president and with A.I.D. encouragement, to reach a Standby Agreement with the IMF. Supplemental ESR III funding of $160 million in September 1984 facilitated submission of a Letter of Intent to the IMF by enabling Costa Rica to reduce its external payments arrears. The nonfinancial public sector deficit for the year, surprisingly, was only 1.6 percent of GDP (although the initial estimate was 2.5 percent), even better than the 3.6 percent figure achieved in 1983.

The new Letter of Intent negotiated with the IMF in October 1984 resulted in approval of a Standby Agreement in March 1985, and the fiscal and monetary restraint begun in late 1984 was continued. The Government of Costa Rica committed itself under the new Standby to holding the 1985 deficit of the nonfinancial public sector to 1.5 percent of GDP. Under an agreement with the World Bank for a Structural Adjustment Loan (SAL), approved belatedly by Costa Rica's legislature in August 1985, the Government of Costa Rica further committed itself to a longer term program for reducing the size of the public sector. A.I.D.'s ESR IV program, approved in late January 1985, included covenants restricting banking system credit to CODESA and the National Production Council and calling for adherence to the Central Bank's overall credit program for 1985.

In February 1985 the Government of Costa Rica published regulations providing specific guidelines for selling CODESA's subsidiaries to private buyers, and a National Commission for Divestiture of CODESA was formed. Progress in actual divestiture during the year was slow, however, and only at the end of the year were the initial steps taken to sell the first CODESA subsidiary (ALUNASA, an aluminum milling company).

As for more immediate fiscal concerns, the deficit target for 1985 was not met, with the actual deficit amounting to 2.0 percent of GDP (although the initial estimate was only 1.7 percent). This performance was disappointing but certainly not highly disturbing, especially because it was affected by the campaign for presidential elections in 1986. One factor in the higher than anticipated deficit was the Costa Rican Government's failure to comply with an ESR IV covenant prohibiting the extension of credit by the banking system to the National Production Council to cover losses resulting from subsidies for basic food commodities. Delays in the legislature's approval of the World Bank SAL, as well as fiscal problems, caused the Government of Costa Rica to fall out of compliance with the IMF Standby Agreement until an IMF Mission in August negotiated a substantial mid-course correction with new fiscal targets. By December, however, the Government of Costa Rica was again out of compliance with the Standby and forfeited the last two tranche drawings, in large part because of SAL conditionality problems that delayed disbursement of the second SAL tranche.

A.I.D.'s ESR V agreement for FY 1986, signed in June 1986, initially focused on consolidating progress made in previous years, particularly by continuing a sound stabilization program under a new government, which took office in May 1986. When it became clear that considerable time would be needed for the new government to reach agreement with the IMF for a new Standby Agreement, A.I.D. revised its ESR conditionality to place greater emphasis on macroeconomic performance. A target was established for reducing the deficit of the nonfinancial public sector to 1.3 percent of GDP, and limits were placed on Central Bank net lending to the public sector.

In 1986, the fiscal deficit target of 1.3 percent was missed, although not by much: the actual deficit is believed to have been about 1.5 percent, slightly lower than the (still preliminary) 1.9-percent figure for 1985. However, overall revenue performance was somewhat disappointing. Preliminary but partial data for the consolidated nonfinancial public sector show a slight increase in the ratio of current revenue to GDP, but less than one would have expected given the sharp increase in coffee prices in 1986. Current expenditures in 1985 were held in check, apparently declining marginally as a percentage of GDP, but capital expenditures increased significantly (not necessarily an undesirable change, given their depressed level in recent years).

The ESR VI program for FY 1987 was not negotiated until well into the U.S. fiscal year, which has been the pattern in recent years. Negotiations between the Government of Costa Rica and other external agencies (the IMF for a new Standby Agreement and the World Bank for a new Structural Adjustment Loan) have also been prolonged, as have negotiations with foreign commercial banks over rescheduling of Costa Rica's external debt. Nevertheless, the Government of Costa Rica committed itself to a sound economic and financial package for 1987. A letter of intent to the IMF was approved by the IMF at the technical level in April but not forwarded to the IMF Board pending an agreement between the Government and the commercial banks on debt rescheduling. Because the commercial banks appeared unwilling to agree on terms with the Government of Costa Rica until they first reached agreement on rescheduling of the Brazilian debt, the IMF decided to forward the letter of intent to its Board, which approved it in late October. The new Standby Agreement reportedly includes, as a performance criterion and not just a target, a ceiling on Government expenditures in 1988.

Fiscal restraint is a key part of the Costa Rican Government's economic and financial program for 1987, and a covenant under ESR VI requires the Government of Costa Rica to fully implement its credit program for 1987, including the imposition of limits on credit to the public sector. A tax package is now being discussed in Costa Rica's legislature, where it has encountered serious opposition. The Government has announced that if it is not passed, it will make expenditure cuts in specified areas to meet the fiscal targets. It is hoped that the deficit of the nonfinancial public sector in 1987 can be held to 0.7 percent of GDP.

In summarizing the relationship between A.I.D. (and other donor) conditionality and Costa Rica's fiscal performance, it is necessary to rely on judgment rather than "objective criteria." Although there was widespread public support for the drastic fiscal measures taken in 1982 and 1983, its seems likely that the significant balance of payments assistance provided directly and indirectly (i.e., through debt rescheduling) by A.I.D. and the IMF made it easier for the Government of Costa Rica to implement fiscal reforms, especially by raising revenues in the decentralized agencies and state enterprises. But despite continued high levels of external assistance, the entry of the World Bank into the fiscal reform policy dialogue, and improvements in per capita GDP, additional progress in reducing the fiscal deficit since 1983 has been relatively slow. Still, the trends are in the right direction, and donor pressures probably have facilitated this movement.

Perhaps there would have been less donor concern with a nonconsolidated public sector deficit averaging a modest 1.7 percent of GDP during the 1984-1986 period had there not also been significant Central Bank losses, which could not be eliminated immediately because of commitments made under the multiple exchange rate practices of the early 1980s and under direct Central Bank borrowing at that time. Although these losses, too, are declining, they still averaged 4.6 percent of GDP during this period. Because the monetary effects of Central Bank losses are similar to those of the fiscal deficit, there is reason to be concerned that the combined financial/nonfinancial public sector deficit during the 1984-1986 period averaged 6.3 percent of GDP.

The evaluation team believes that this high combined deficit partly explains the continued strong donor pressure to further reduce the nonfinancial public sector deficit. Another likely explanation of these pressures is that effective structural adjustment requires a transfer of additional public sector enterprises and functions to the private sector, a view held by A.I.D. and the World Bank.

5.4 Financial Performance

The relation between economic recovery, stabilization, and growth on one side, and monetary or domestic credit expansion on the other, is crucial in judging the effects of the World Bank, IMF, and A.I.D. programs in Costa Rica. Ultimately, monetary policy and availability of financial resources affect stabilization and growth through their impact on domestic investment. Studies on investment behavior indicate that in contrast to modern industrial countries, one of the principal constraints on investment in developing countries is the availability of financial resources, rather than their cost. Even when adjusted for risk, rates of return on capital investment are typically higher than real interest rates on loanable funds, which before the current program were kept artificially low by the Government. It is generally the case that administrative control of interest rates at low real levels results in chronic excess demand for capital. Investments with low rates of return often receive priority over higher yielding investments.

This type of economic inefficiency was more prevalent in Costa Rica before the implementation of conditionality reforms supported by A.I.D. and other international donors. Although numerous subsidized interest schemes still affect Costa Rica's economy, important improvements have been made. As indicated by a Costa Rican banker, credit in Costa Rica is still scarce for "non-blue chip" borrowers in some economic sectors. In addition, positive domestic interest rates will influence private investment indirectly because an increase in the real return on financial assets stimulates a larger volume of financial savings by the domestic private sector.

Studies have also tended to confirm the hypothesis that, in developing countries, credit extended by the banking system can have a sizable impact on real private capital investment. Considerable empirical evidence indicates a positive relationship between growth and investment in developing countries; this relationship would indicate that increases in domestic credit--as occurred in Costa Rica under the Cash Transfer program--improve growth through their impact on private investment.

5.4.1 International Flows

A major accomplishment of the Cash Transfer program was its ability to provide external financial support for recovery from the 1980-1982 financial crisis. According to numerous economic indicators, Costa Rica's economy has only recently recovered the levels of economic activity that existed before the crisis. Funding under the Cash Transfer program has thus been critical in preventing a major recessionary slide into another financial crisis.

With inflation down from triple digit annual rates to a 10-20 percent range, and the budget deficit dropping as a percentage of GDP, the remaining key factor in stabilizing the economy is the trade deficit and its associated foreign debt. Overall, A.I.D. conditionality has been weaker than that of the IMF, which may be justified in that complete closing of the current account gap of the balance of payments is not needed. Rather, the deficit in the current account of the balance of payments must be limited by what can be covered by the inflow of capital from abroad in the form of equity, long-term debt, normal trade credits, or foreign aid.

The current situation limits the extent to which capital is likely to flow into Costa Rica in the form of equity, long-term debt, or normal trade credits. If foreign aid is to drop in the medium term without recessionary consequences, the difference must be made up by some combination of increased exports or decreased imports. Given the recent growth of nontraditional exports, which has been encouraged by the Cash Transfer program, there is a good possibility that the trade balance will be turned around (see Appendix B and Table B-3).

The major performance indicators--including the outstanding debt-to-GDP ratio and the current account deficit as a percentage of GDP--have not shown substantial improvement over the last few years. The debt service position has generally been dependent on the presence of debt rescheduling agreements. This performance is not poor, however, in comparison with that of other Latin American economies.

5.4.2 Domestic Banking

A major accomplishment of the A.I.D. Cash Transfer program in the financial sector has been the liberalization of the private banking system. Private banks now have guaranteed access to a growing proportion of Central Bank funding, and restrictions on their deposit-taking are being relaxed. Several people interviewed for this evaluation indicated that Costa Rica would have moved in the direction of liberalizing private financial markets even without explicit A.I.D. and IMF conditionality provisions, but the implementation of reforms would have been far slower.

As an example of the financial development that has occurred since the start of the Cash Transfer program, Table 7 shows the high growth of National Securities Exchange transactions between 1982 and 1986; the total value of transactions grew from ₡4.8 billion to ₡82.1 billion during this time. Placements of credit paper (investment certificates) issued by nonfinancial private firms through this organized securities market grew from ₡0.1 billion in 1982 to ₡7.1 billion in 1986 and represented a rising proportion of total transactions recorded in the National Securities Exchange, growing from 2.6 percent in 1982 to 8.7 percent in 1986.

Transactions of private sector financial assets grew from 8 percent of total transactions in 1982 to 25 percent in 1986. But public sector financial assets--Government bonds, Central Bank stabilization bonds, and certificates of deposits--issued by state-owned banks account for about 69 percent of this increase. This represents a shift in deficit financing. Until 1982, the public sector deficit was financed primarily through the Central Bank and state-owned banks. However, under IMF stabilization guidelines, limits have been set on the banking system credit extension to the nonfinancial public sector. Thus, since 1982, the public sector deficit has been financed mainly by sales of Government bonds to the private sector through the National Securities Exchange.

Table 7. National Securities Exchange Transactions in Costa Rica, 1982 and 1986

Transaction	Millions of Colones		Percent of Total	
	1982	1986	1982	1986
Equity	5	72	0.1	0.1
Bank Acceptances	0	589	0.0	0.7
Bonds[a]	600	39,906	12.5	48.6
CAT[b]	271	1,530	5.6	1.9
Certificates of Deposit	3,176	16,712	66.0	20.4
CDs Presa	395	340	8.2	0.4
Investment Certificates[c]	124	7,116	2.6	8.7
Other[d]	242	15,832	5.0	19.2
Total	4,813	82,097[e]	100.0	100.0

[a]Government bonds and Central Bank stabilization bonds.

[b]Tax credit certificates.

[c]About two-thirds of investment certificates are term deposits issued by private banks and private finance companies and about one-third are investment certificates issued by nonfinancial private firms.

[d]About 50 percent of these transactions consist of mortgage participation certificates and certificates of deposit issued by savings and loans associations.

[e]Annual turnover of transactions has been estimated at about 4.9 in 1986. Therefore, this volume of transactions corresponds to a stock of about ₡16.8 billion.

Source: National Securities Exchange of Costa Rica.

The overall level of issues by nonfinancial private firms remains small. Equities also remain small, constituting only 0.1 percent of total transactions for both years. The low values indicate little direct contact between primary borrowers (investors) and lenders (savers) for a variety of reasons, ranging from savers' risk perceptions to economies of scale and tax laws.

State banks have not been able to adequately service the growing needs of Costa Rica's economy. More than 30 percent of loans from state-owned banks are more than 90 days past due. One factor is that loans are often awarded on the basis of political influence. Also, state-owned banks must comply with development guidelines rather than commercial considerations. In addition, foreclosure proceedings are often withdrawn because of political pressures.

However, the role of private banks increased substantially from 1982 to 1986 due to Cash Transfer funding. A.I.D. Cash Transfer conditionality provisions helped effect a reform of the Central Bank Law, enacted in late 1984, that opened a direct rediscount operations window in the Central Bank. Private bank lending to the private sector grew from less than ₡0.5 billion in 1982 to ₡6.7 billion in 1986, as shown in Table 8. However, of total banking system credit, the contribution of private banks to the private sector is still low, constituting only 16 percent of total credit as of December 31, 1986 as compared to 84.4 percent for state-owned banks.

Financial reform continues to be a top priority for the 1987 ESR agreement. The financial policies addressed include mini-devaluations, market-determined interest rates, and a limitation on subsidized credit. In addition to continuation and consolidation of these previous financial reforms, the new agreement requires the Central Bank to prepare an economic plan, which includes fiscal and monetary limits. This late addition to the package was necessitated by the unexpected absence of an IMF Standby Agreement. Provision was also made to develop a similar plan in 1988 if no agreement is reached with other donors and creditors.

5.5 Employment, Equity, and Basic Needs

The Costa Rica Cash Transfer program has had a positive effect on employment and equity in Costa Rica, compared with the situation that would have prevailed in its absence. The wage, employment, and social indicators delineated in Appendix B show

Table 8. Regulated Financial Sector Total Credit Outstanding[a] to Costa Rica's Public and Private Sectors, 1982 and 1986
(millions of colones)

Financial Sector	1982 To Public Sector	1982 To Private Sector	1986 To Public Sector	1986 To Private Sector
Central Bank	13,221	0	48,133[b]	0
State-Owned Banks[c]	3,480	17,123	5,909	36,185
Private Banks	112	422	494	6,677
Private Finance Companies	50	601	414	2,473
Other Financial Institutions[d]	2,487	8,617	15,463	20,701
Total	19,350	26,763	70,413	66,036

[a]Loan and securities portfolio.

[b]Includes public sector rescheduled external debt assumed by the Central Bank.

[c]Includes mortgage departments of state-owned banks, the rural department of Banco Nacional, and the housing department of Banco Credito Agricola.

[d]Comprises the Popular Bank, the National Housing Institute, the Institute for the Promotion of Cooperatives, CODESA, the Teachers Savings and Loan Association, the Costa Rican Social Security System, the Institute for the Development of Municipalities, and savings and loan associations.

Source: Central Bank of Costa Rica.

that the poor and middle classes have gained substantially from Costa Rica's economic recovery (Fields 1986). Poor and middle-income families may be the most important beneficiaries of the recovery program and, as the analysis in Appendix B suggests, they have proportionately more to lose were the economy to revert to another crisis.

Ironically, there has been a tendency during policy discussions to incorrectly attribute equity adjusted costs entirely to the measures designed to overcome the crisis, rather than to the crisis itself and its determinants. There has been a tendency to attribute social costs to the medicine, rather than to the illness, and a parallel desire to deal with the symptoms, rather than with the causes of the problem. These social costs have represented a difficult test for the country, and the fact that they have not resulted in major social disturbances reflects the strength and stability of Costa Rica's institutions.

5.5.1 Employment

As the Costa Rican economy has improved, so has the labor market (Fields 1986, 38-40). Statistics indicate substantial gains for wage earners and employment and job composition trends indicate that labor market conditions have improved. Employment increased by 27,000 between July 1982 and July 1984. Private sector employment held steady, while public sector employment grew nearly 20 percent (although public sector growth was lower in terms of "full-time equivalent" jobs). The low-earning category of "unpaid family workers" has fallen in number, and higher paid "wage and salary" employment has grown since the economic crisis of 1980-1982.

The composition of the work force has improved, with the relative labor force shares of higher paid professional, technical, administrative, managerial, and sales workers all increasing. Agricultural employment has fallen relative to nonagricultural employment. Moreover, the labor force reverted to its pre-crisis levels within the first year of recovery as non-heads of household (wives and children) withdrew from the labor force.

Household surveys (usually taken three times a year) found that real wages increased by 13.2 percent in 1984 and 5.4 percent in 1985. Payroll data (of workers subject to social security and health benefits) indicate an 8.7-percent increase in average real wages in 1985 and a 3.4-percent rise in 1986 (through July). The unemployment rate dropped from 9.5 percent in March 1982 to 7.8 percent in March 1984, 6.3 percent in March 1985, and 6.1 percent in March 1986.

5.5.2 Equity and Basic Needs

Fortunately, the resiliency of Costa Rica's institutions and economic system acted to alleviate some of the negative effects of the 1980-1982 financial crisis. During 1980-1981, labor force participation rates increased as real wages declined sharply and non-heads of household entered the labor force in an attempt to maintain family incomes (Pfefferman 1987). Because the poor have school dropout rates far higher than the rest of the population, an increase in poverty can be measured by a drop in school enrollment rates. In Costa Rica, dropout rates peaked in 1982 and declined slightly in 1983, in a manner consistent with increased labor force participation by non-heads of household (Pfefferman 1987). As indicated in Appendix B, most social performance indicators continued to improve during and after the crisis.

Not all social indicators improved, however. The Gini coefficient for Costa Rica rose from 0.44 to 0.47 between 1971 and 1983, indicating increased income concentration. This finding seems reasonable because the 1983 figures were taken at the end of the financial crisis. During the same period, the upper 10 percent of the urban population experienced a substantial increase in income. These findings suggest that the poor and middle-class wage earners were hit the hardest by the recession.

The continuing improvements in social indicators through the 1980s suggest that, to some extent, Costa Rica has been able to protect the poor, particularly the children, from the adverse effects of declines in national income. This appeared to be achieved by effectively targeting social services to the most vulnerable groups, which was made possible by the existence of a reasonably efficient bureaucracy (Pfefferman 1987, 34). In the absence of the Cash Transfer program, it is unclear how long these positive trends in social indicators would have continued had the financial crisis been prolonged. It is likely, however, that had the crisis persisted and Cash Transfer support not been given, some of the indicators would have shown a deterioration.

The high level of social well-being, even during Costa Rica's financial crisis and subsequent recovery, are documented in Appendix B and discussed by Pfefferman (1987). It appears that the poor and middle classes were hurt more from the decline in their real income than from diminished availability of social services during the 1980-1982 crisis.

In conclusion, poor and middle-class wage earners have been the major beneficiaries of the ESF Cash Transfer program during

Costa Rica's recovery and its movement toward economic stability and growth. Wage rates, employment, and incomes of these groups have grown substantially since 1982. Because of the equitable distribution of Government services, A.I.D.'s efforts to improve the macroeconomic environment rather than targeting special disadvantaged subgroups was appropriate. The relatively efficient Costa Rican bureaucracy appears to have been successful at continuously raising the country's social indicators during and after the 1980-1982 crisis.

5.6 Agriculture

The Cash Transfer local currency program established a trust fund for the Agricultural School for the Humid Topics (EARTH). The school will be located in the northern zone near Nicaragua and is expected to be a source of qualified technicians and entry-level management for agricultural enterprises operating in humid tropical areas of Latin America. It is intended to be a 4-year undergraduate institution with a course of study leading to a Bachelor of Science degree in agriculture. When in full operation, it will have a student body of approximately 400 students and 40 faculty members. The agricultural land owned by the school will be used to produce crops to help offset its operating expenses. No scholarships are proposed for the students, although work opportunities may be available on the school's farm to help them cover some tuition costs. It is premature to evaluate the impact of this project on Costa Rica's agricultural sector, but an examination of the project's supporting documents suggests some problems.

EARTH and the Tropical Agricultural Research and Training Center have been supported by $105 million in local currency equivalent, which represents over 20 percent of total local currency generated by the Cash Transfer program in Costa Rica since 1982--second only to the local currency earmarked for the CODESA divestiture. Much of EARTH's funding (soon to be over $50 million) is being placed in an income-earning "trust," controlled by five voting members (three from the United States, two from Costa Rica) and one nonvoting member from A.I.D. The "trust" in this project represents over 1 percent of Costa Rica's GDP and may be the single largest trust in the country.

The evaluation team judges funding of this program to be an inappropriate use of Cash Transfer monies. Its expected development impact is limited because of a low economic rate of return.

The EARTH Project Paper includes data that suggest that even the most optimistic internal rate of return projections are too low to justify the project. This type of analysis is particularly applicable in Costa Rica, where market-controlled interest rates suggest numerous investment opportunities yielding much higher returns than those indicated for EARTH. The internal rate of return estimates presented in the Project Paper (based on various assumptions) range from 5.3 percent to 13.4 percent--all significantly below borrowing rates in Costa Rica, which are generally in the middle 20-percent range. The Project Paper's economic analysis suggests that it is not reasonable to expect an annual rate of return above 12 percent.

6. CONCLUSIONS AND RECOMMENDATIONS

This section summarizes the recommendations developed throughout this report on the Cash Transfer program in Costa Rica, organizing them in terms of the major program issues identified over the course of the evaluation. This section also begins the task of expressing the "lessons learned" from the series of Cash Transfer evaluations, although a thorough treatment of these broader conclusions must await the completion of several more evaluations of Cash Transfer programs in other nations.

6.1 Issues

The following issues (presented in question form) represent the perspectives of the major institutional participants in the Costa Rica Cash Transfer program, including the Government of Costa Rica, USAID/Costa Rica, A.I.D., the IMF, the World Bank, and the U.S. Congress. Also included are the evaluation team's conclusions, presented as brief answers to the issues below.

-- Have the stability goals of the Cash Transfer program been met?

  Yes. The Cash Transfer program in effect supported the Costa Rican balance of payments during the economy's recovery period, allowing a transition to the policy-reform phase.

-- Have the structural adjustment goals of the Cash Transfer program been met?

  Yes, for the most part. Although privatization has been slow and effective tariffs have fallen very little, most policy reform goals have been met. In particular, exchange rates have been unified and (approximately) correctly valued; divestiture of the Costa Rican Development Corporation (CODESA) has begun; nontraditional exports have performed well; and the private banking sector has gained stature.

-- Has the A.I.D. dollar transfer program functioned in conjunction with other donor policy-reform programs?

Yes. Conditionality provisions in general are consistent among the programs, and contradictions have not been serious. Occasional IMF complaints concerning excess credit creation seem unfounded.

-- Have A.I.D. Cash Transfer conditionality provisions been well-designed and effective?

Yes, with some exceptions. Covenants and conditions precedent have been reasonable, comprehensive, and understandable. Problems with timing (e.g., the unrealistic CODESA divestiture timetable) are probably due to the 1-year time frame of each of the Economic Stabilization and Recovery Agreements (ESRs).

-- Has the Government of Costa Rica conformed to A.I.D. conditionality provisions?

Yes, with few exceptions. The CODESA timetable mentioned above has been the major "violation." Other problems, including certain reporting requirements and port repair scheduling, have been minor.

-- Has the Government of Costa Rica performed as a full partner in the international policy development process?

Yes, in every sense except that of policy analysis. Both the executive and legislative branches of the Government of Costa Rica have taken part in the development and implementation of internationally encouraged policy programs. The next step for both branches is the development of policy analysis capabilities.

-- Has the Costa Rican local currency program been successfully administered?

Yes, with certain exceptions. The number of projects involved in this program has been so large that some mistakes were bound to occur. The administrative system developed by USAID/Costa Rica has functioned very well, however, as have the majority of the projects funded.

-- Should the Central Bank of Costa Rica pay interest on the A.I.D. Special Account?

Yes, as long as that interest is reimbursed by USAID/ Costa Rica upon Costa Rica's successful completion of the expenditures and conditionality involved.

-- Who owns the local currency generated by the Cash Transfer program?

The Government of Costa Rica "owns" the currency for future ESRs, although USAID/Costa Rica has effectively controlled it under earlier ESRs.

-- Should Cash Transfer-generated local currency be "sterilized"?

Yes, to the extent necessary to stay within agreed-on credit creation limits.

-- Is the local currency program necessary and desirable?

Yes and no. That is, it has been quite necessary for certain projects (e.g., the CODESA divestiture), but its uses are limited, and in the future the program might best be discontinued.

6.2 Recommendations

The following recommendations about the design, implementation, and management of the Costa Rica Cash Transfer program are derived from the above findings.

1. The uses and administration of Economic Support Fund (ESF) dollars under the Cash Transfer program should be more explicitly confined to the short-term (stabilization) and intermediate-term (structural adjustment) funding for which the program was originally intended. In particular, the Mission should demonstrate that each project and condition involved has a short-term performance indicator and termination date and will not lead to a Government dependency on Cash Transfer funding. This recommendation does not imply that the structural adjustment supported by the Cash Transfer program should not consist of long-term changes, but only that Cash Transfer funding should not be long term.

2. Timetables for specific economic adjustments should be set more realistically. Even though the ESRs have had 1-year horizons, the individual local currency projects could be designed in more realistic 1-year stages rather than projected for full completion in 1 year.

3. USAID/Costa Rica should encourage the formation of competent economic policy analysis offices for both the executive and legislative branches of the Government of Costa Rica.

4. The number of local currency projects for each ESR should be strictly limited (10 projects would be a reasonable maximum), thereby allowing the Mission staff to more effectively administer a manageable number of activities.

5. The degree of Mission autonomy in the selection and design of local currency projects should be moderately limited by requiring project-level documentation for larger projects, similar to that required for Development Assistance projects.

6. Interest should be charged on the unexpended balance of the A.I.D. Special Account (local currency funds from Cash Transfers), but USAID/Costa Rica should systematically reimburse that interest (using sterilized funds) as the projects involved are implemented.

7. The issue of ownership of local currency funds should be left ambiguous as long as possible, but ownership and control should be assigned to the Government of Costa Rica when necessary.

8. If the local currency program becomes too cumbersome or otherwise problematic, it should be discontinued.

6.3 Lessons Learned

Certain broad conclusions concerning the management of ESF Cash Transfers can be drawn from the Costa Rica evaluation, even though it is the first in the series of Cash Transfer program evaluations. The following general conclusions are tentative, but are supported by the experience and background of the evaluation team.

1. Future Cash Transfer programs should be designed to be phased out. USAID Missions should be able to show that (a) individual local currency projects will have full impact and can be discontinued within 3 years, (b) Cash Transfer program objectives can be fully met within 5 years, and (c) no long-term dependency

results from the Cash Transfer program, either on the part of host country governments or private sector organizations.

2. Future programs should contain specifications for Mission-level administration of both dollar and local currency funds and for the permissible level of Mission discretion in the use of funds. For both these areas, the control systems applied to larger projects should approximate those used to monitor A.I.D. Development Assistance projects.

3. Future programs need not necessarily include a local currency component. Although such a component is often very useful, its costs can outweigh its benefits in some cases. The decision to implement a local currency component should be made on a case-by-case basis.

APPENDIX A

METHODOLOGY OF CASH TRANSFER EVALUATIONS

This appendix presents a general approach to evaluating the impact of A.I.D.'s Cash Transfer programs and identifies the procedures used in the Costa Rica program evaluation. The general methodology developed during the Costa Rica study is intended to be used for the other country studies in this series.

1. GENERAL APPROACH

The following basic assumptions about the operation of Cash Transfer programs underlie the methodology to be used for this evaluation series, determining both the issues addressed and the analytical models for addressing them:

-- of the Cash Transfer programs can be as- ...ms of identifiable performance indicators, ... related statistically and conceptually to the degree of program activity.

-- Although specific performance indicators may differ from country to country, they should be specified in a consistent manner and should reflect the general program goal of enhanced economic development.

-- The impacts of A.I.D.'s Cash Transfer programs cannot be reliably separated from those of similar, overlapping policy programs, including those of host country governments, the World Bank, or the International Monetary Fund (IMF).

-- A.I.D.'s Cash Transfer program differs from other international policy programs in its inclusion of "local currency" projects. The administration and implementation of these projects may have impacts entirely separate from impacts from the original transfer of dollars.

-- Whereas Cash Transfer programs are intended to provide immediate balance of payments support and to enhance long-term economic development, they operate initially through host country public policy and institutions, and so affect actual economic behavior with a variable and sometimes considerable lag.

-- Procedures for implementing and monitoring Cash Transfer programs may affect performance indicators as heavily as does the actual transfer of dollars. Program administration is thus a legitimate issue in the analysis of economic development impact.

-- The basic goals of stabilization and structural adjustment programs such as those of A.I.D., the IMF, and the World Bank are economically sound and their fundamental desirability need not be analyzed in this study.

-- The external debt problem of developing countries is a worldwide phenomenon not specific to Cash Transfer recipients and unlikely to be resolved by the Cash Transfer program.

These assumptions lead to the following elements of the methodology:

-- Both descriptive and analytical material are classified into categories corresponding to types of performance indicators. This approach applies to economic, policy-oriented, and administrative information and analysis.

-- Program impact analysis differentiates between <u>policy and institutional</u> effects and <u>economic development</u> effects. Economic development trends are expected to lag policy changes in a variable manner.

-- A.I.D. Cash Transfer programs are described separately from World Bank and IMF programs for clarity, but differential impact is imputed to those programs only when absolutely clear linkages can be identified. Such linkages are likely to be more common at the level of public policy than of economic performance.

-- The analysis of USAID Mission local currency programs is separated from that of the A.I.D. transfer of dollars. These programs are often implemented at the microeconomic level, with objectives and impacts different from those of the original transfer of dollars to the host country central bank. Thus, although specific projects may have micro-level impacts, they are addressed in terms of the policy categories presented above.

-- Formal statistical models of the host country economy are used when the models are sufficiently specified and disaggregated to allow testing of hypotheses about specific performance indicators. Otherwise general statistical trends are preferable to modeled conclusions.

-- Interviews, although structured according to performance indicator groups, focus on policy impacts and administrative procedures of the Cash Transfer programs rather than on final economic impacts. Although subjective orientation might bias a respondent's report of actual economic impacts, trying to measure that orientation was an important element of the analysis of policy impact and administrative procedures.

-- Although the issue of the progress of external debt management by Cash Transfer recipients is addressed, the failure to resolve external debt problems is not interpreted as a failure of the Cash Transfer program.

Several of these elements of methodology deserve further elaboration. Sections 1.1 and 1.2 address performance indicators and local currency versus dollar transfer impacts, respectively.

1.1 Performance Indicators

Although the conditions precedent and covenants attached to Cash Transfer programs vary in detail by country, the basic objectives of the programs are fairly standard. In addition, the basic policies of the USAID Missions involved are all consistent with general U.S. policy, and the economic settings of the host countries are similar. For these reasons, the various Cash Transfer programs are expected to exhibit similar measurable objectives.

These objectives will be labeled "performance indicators" and will be defined by reference to USAID Mission Country Action Plans, Program Assistance Approval Documents, and Cash Transfer covenants. Initial investigation indicates a brief list of basic indicators focused on private sector development, the balance of payments, nontraditional exports, fiscal policy, employment creation, and agricultural development. The measurement of these indicators will be determined in the course of the pilot study and applied to the remaining country studies in the series.

1.2 Local Currency Versus Dollar Transfers

The A.I.D. Cash Transfer program is unlike World Bank and IMF programs in one very important respect: the latter policy programs do not generate a fund of local currency for the use of or control by these organizations. A.I.D. Cash Transfers do generate such funds, although the precise mechanism for their generation and the precise uses to which they are put seem to vary considerably among the USAID Missions.

In the countries selected for the first series of Cash Transfer evaluation (Costa Rica, Jamaica, the Dominican Republic, and Honduras), some USAID Missions manage the local currency directly, while others attribute the funds to budget categories. Obviously the impacts of such funding will vary and may not be amenable to the same sort of macroeconomic analysis as are the impacts of the dollar transfer components of Cash Transfers.

In no case is the analysis for this evaluation series intended to cover the micro-level impact of each local currency project. The projects will be classified according to the policy impact categories described above, the most important projects will be selected, and the aggregate impact of local currency expenditures will be examined by policy category.

The above elements of methodology are applicable to all country studies in this series. In each country, however, certain economic and program-related characteristics will require special treatment, as is indicated in the next section.

2. SPECIFICATION FOR THE COSTA RICA CASE

The Costa Rica Cash Transfer program differs from that of most other programs in terms of size, administration, and conditionality. In general, it is larger and more varied in scope than many similar programs in the Latin America and Caribbean region. For that reason, relatively more time was dedicated to policy and administrative analysis for the Costa Rican study, and that analysis proceeded in a fairly structured manner. The following highlights are of particular interest in terms of methodology.

-- A.I.D.'s Costa Rica Cash Transfer program is larger than the IMF and World Bank programs combined. It is also more creatively managed, especially in terms of local currency projects. Consequently, the team devoted less effort to the analysis of World Bank and IMF activities.

-- For the same reason, the team devoted more effort to the Costa Rica local currency program, addressing the sectoral and industrial-level impact of several specific projects.

-- As expected, policy analysis was more profitable than economic development analysis in many cases. Several of the larger policy programs (e.g., divestiture of the Costa Rican Development Corporation) have yet to show actual economic effects.

-- Econometric modeling and formal statistical analysis were not useful in evaluating the Costa Rica program because of the lack of appropriate disaggregation of existing models and data.

APPENDIX B

MACROECONOMIC TRENDS IN COSTA RICA, 1960-1987

Costa Rica's reputation as a model developing country during the 1960s and 1970s was based on its economic growth, good export performance, quality of life, and equitable distribution of social services. This performance was impressive, but it concealed certain structural weaknesses in Costa Rica's economy that generated negative economic impacts as world petroleum prices increased and international commodity prices decreased during the late 1970s and early 1980s.

Those weaknesses included (1) a dependency on traditional agricultural exports and exports to the Central American Common Market (CACM), (2) weaknesses within CACM itself, (3) an overvalued exchange rate, (4) excessive Government intervention (including ownership) in private sector production, (5) excessive s id control of producer and consumer prices, (6) a r oncompetitive banking system, and (7) subsidized, c :est rates. Within this institutional context, the international price shifts of the late 1970s led to negative economic growth, increased unemployment, and significant public indebtedness in Costa Rica in the early 1980s.

From 1982 to 1987, the Costa Rican economy improved significantly: positive income growth returned, new capital formation increased, and nontraditional exports to non-CACM markets grew. In conjunction with international donor stabilization and structural adjustment programs, Costa Rican Government policy reform has addressed and at least partly resolved many of the structural weaknesses listed above.

This appendix describes Costa Rican macroeconomic trends from the 1970s through 1987, concentrating on the seven policy categories described in Section 1 of the main report. The impact of the A.I.D. Cash Transfer programs and other international donor programs on these trends is analyzed.

1. PRODUCTION AND PRIVATE SECTOR DEVELOPMENT

The structure and rate of growth of gross domestic product (GDP) in Costa Rica since 1970 have depended largely on the policies of the Government of Costa Rica and international markets. These policies and the development of the national economy have passed through three distinct stages: (1) strong economic growth from 1960 through 1980, based largely on protected production for domestic and regional markets; (2) precipitous economic decline from 1980 through 1982, brought on by structural weaknesses that rendered the economy unable to respond to changing terms of trade; and (3) economic adjustment and partial recovery from 1983 through 1987, the time of this evaluation. Table B-1 outlines certain aggregate economic trends involved in these stages.

Table B-1. Real Average Annual Change in Selected Economic Indicators for Costa Rica, 1960-1970 to 1983-1986 (percentages)

Indicator	1960-70	1970-80	1981-82	1983-86
GDP	6.5	6.0	-4.8	4.0
Manufacturing	9.4	7.9	-6.0	5.6
Agriculture	5.7	2.6	0.2	3.0
Gross Private Domestic Investment	7.1	8.5	-31.6	16.5
Consumption	6.3	5.5	-8.9	5.0

Source: Central Bank of Costa Rica, April 1987 revisions.

During the 1960s the Government of Costa Rica joined CACM in instituting a series of protectionist policies directed at promoting production for domestic and regional markets. These policies--including high tariffs on non-CACM consumer products, subsidies for manufacturing within CACM, export taxes, selective export credits, and selective tax exemption--had the effect of increasing consumer prices, biasing production against exportation outside the region, limiting plant size and efficiency, and eventually limiting investment itself. At the same time, however, GDP and manufacturing output grew strongly, with manufacturing's share of GDP increasing from 14.2 percent in 1960 to 18.6 percent in 1970 and 22.0 percent in 1980.

By the early 1970s, the Government of Costa Rica recognized at least part of the economic distortion caused by its import-substitution policies and attempted to correct certain price and investment biases. It created the National Production Council (CNP) to control consumer prices of basic foodstuffs and to subsidize certain types of agricultural production. The national holding company, the Costa Rican Development Corporation (CODESA), was also a product of this era, initially meant to provide venture capital for new investment but eventually becoming owner or part-owner of several subsidiary corporations and affiliates. However, these moves only distorted the production system further. By 1980, CNP was incurring losses equal to 40 percent of the national budget deficit, and CODESA losses absorbed 30 percent of public credit availability. In that same year, manufacturing output grew by only 0.8 percent and agricultural output fell by 0.5 percent. Further, the Costa Rican economy was ill-equipped to adjust to changes that were beginning to occur in the international economy.

As is evident from Table B-1, production, investment, and consumption declined sharply during 1981 and 1982. In 1982, real per capita GDP fell to 86 percent of its 1980 level, a level it has still not regained. CACM offered a declining market for Costa Rican production, and very little of the country's protected domestic industry was able to compete in broader international markets. In addition, the inefficient producers supported by CNP and CODESA absorbed most of the public credit, so that private sector firms had limited access to financing for modernizing and restructuring in order to grow by exporting.

During 1983, the Government of Costa Rica began plans to divest CODESA holdings and decrease the operating losses of CNP. At the same time, A.I.D. began supporting private sector restructuring efforts, such as the Costa Rican Coalition for Development Initiatives (CINDE) investment promotion program, and other policy programs of the International Monetary Fund (IMF) and the World Bank also began to affect the private sector. Much of the economic turnaround of the 1983-1987 period is due to these programs (their actual impacts are analyzed in later sections of this appendix). The important point here is that, beginning in 1983, domestic production, domestic investment, and foreign investment in Costa Rica began to improve and have continued growing through 1987. During this period, public institutions directed at nationalizing and/or controlling the private sector progressively became less influential, interest rates were partially decontrolled, the growth of the public sector was slowed, and the exchange rate was unified. In summary, liberalization of the regulatory and trade regimes was accompanied by renewed economic growth in this period.

2. INTERNATIONAL TRADE PERFORMANCE AND POLICY

2.1 Export Performance

During the 1960s and most of the 1970s, Costa Rican exports grew rapidly, providing the foreign exchange needed for steady growth in imports and overall economic activity. During the 1960-1979 period, export value increased by an average of 13.5

percent per year. GDP growth averaged 6.1 percent, or 3.3 percent on a per capita basis. The rapid export expansion was due to two principal factors: growth in volume to world markets, combined with favorable prices for four traditional products (coffee, bananas, sugar, and beef), and rapid growth of exports of industrial products to CACM, which was established in 1960. For CACM, Costa Rica's exports, consisting almost entirely of manufactured goods, increased from $2 million in 1960 to $270 million in 1980. Exports of nontraditional products (i.e., everything except coffee, bananas, sugar, and beef) outside CACM also grew during this period, but represented only 17 percent of total exports in 1979.

After 1980, both principal elements of Costa Rican export growth disappeared. Trade within CACM, due to recession and payment difficulties throughout the Isthmus, began to contract sharply. Total CACM exports fell steadily, from $1.1 billion in 1980 to less than $400 million in 1986. Second, world markets for Costa Rica's four traditional exports turned sour. World prices for these exports fell sharply in 1981 and 1982 and, aside from a temporary increase in coffee prices during 1986, have not yet begun to recover.

Moreover, most analysts expect only modest recovery of world prices over the medium term, so that real prices for traditional Costa Rican export products are likely to be significantly lower in 1990 than they were during the 1970s. The price declines for coffee and sugar were compounded by other external factors. For sugar, the reimposition of import quotas by the United States in 1982 has steadily reduced permitted export volumes to Costa Rica's traditional market. And for coffee, the operation of a worldwide quota system under the International Coffee Agreement has limited the potential for sustained increases in coffee export volumes.

In sum, external conditions during the 1980s created a profound structural crisis for the Costa Rican export sector. During the 1981-1987 period, Costa Rica exported a total of $1.4 billion less than it would have over the period had world prices for traditional commodities remained at their nominal 1980 level and had CACM trade continued at the 1980 level.

While export markets deteriorated, import prices continued to rise. To maintain the same real value of imports over the 1981-1987 period, increased export earnings of about $1.3 billion would have been needed. Projections through 1993 indicate no significant improvement in export prices in the medium term. According to these projections, prices in 1993 will still be 30 percent below the 1976-1980 average in real terms. Thus, export growth will need to come primarily from the development of new export products.

The initial Costa Rican response to the balance of payments crisis--heavy external borrowing during the 1980-1982 period--was clearly unsustainable and only added to the magnitude of the structural problem facing Costa Rica when access to borrowing ended in 1982, amid unprecedentedly high world interest rates. With interest payments alone of more than $400 million due in 1982 and foreign exchange reserves depleted, the country was essentially bankrupt. No conceivable mechanism was available to restore external equilibrium in the near term.

The recognition of the export crisis led to a wide variety of actions aimed at generating new sources of export earnings. The announcement of the Caribbean Basin Initiative in 1982 (which actually became operational in January 1984) added further impetus. So far, the results appear to have been highly successful, as shown by Tables B-2 and B-3. Table B-2 shows U.S. imports of manufactured goods from Costa Rica and other Central American countries during the 1982-1987 period (1987 data are projected based on actual data for the first half of the year). As indicated by the table, exports of such products (Standard International Trade Classification [SITC] categories 5-8) rose at an annual rate of 29.5 percent, from $73 million in 1982 to an estimated $265 million for 1987 (based on data for the first 8 months of 1987). The single largest element of the growth was apparel, accounting for about 65 percent of total exports to the United States, but other products have continued to grow at similar rates.

Although no data are available to break down the manufactures total between products produced with high Costa Rican value added and those assembled from imported materials in <u>maquila</u> (drawback) firms, the great bulk of the value of total manufactures is from <u>maquila</u> firms. Consequently, the value added in Costa Rica is far lower than the gross value of these exports. The World Bank estimates that the domestic value added for apparel exports is about 25 percent, although this estimate is not yet confirmed. Nevertheless, the growth in value added has been impressive.

Table B-3 shows Costa Rican export data for nontraditional exports. It excludes exports from export processing zones (for which only the value added is included in Costa Rican statistics, and then as a service export). The export data, which still include a substantial but unknown element of <u>maquila</u> activity from firms not located in export processing zones, show a dynamism similar to the U.S. import data shown in Table B-2. Total exports rose from $139 million in 1983, following a decline from

Table B-2. U.S. Manufactured Imports (SITC categories 5-8)
From Caribbean Basin Initiative Countries, 1983-1987
(millions of dollars)

Country	1983	1984	1985	Estimated 1986	Estimated 1987	Average Growth Rate (%) 1983-87
Belize	6.8	15.6	23.4	20.4	17.0	25.7
Costa Rica	102.3	134.3	166.6	218.6	265.0	26.9
El Salvador	94.7	121.5	90.6	57.3	70.0	-7.3
Guatemala	14.6	27.7	28.4	38.7	60.0	42.4
Honduras	37.4	39.4	45.8	55.5	65.0	14.8
Panama	33.7	33.5	85.6	50.1	60.0	15.5
Total, Central America	289.5	372.0	440.4	440.6	537.0	16.7

Note: SITC is Standard International Trade Classification.

Table B-3. Value of Costa Rican Exports
by Type, 1980-1987
(millions of dollars)

Export	1980	1981	1982	1983	1984	1985	1986	1987
Traditional	560	581	535	526	597	589	682	572
CACM	270	238	167	197	192	129	96	110
Nontraditional	171	184	167	139	209	213	299	390
Total Exports	1,001	1,003	869	862	998	931	1,077	1,072

1980 to 1983, to an estimated $390 million in 1987--an annual growth rate during the 1983-1987 of 22.9 percent.

According to Costa Rican data, only about 55 percent of the nontraditional exports outside CACM were destined for the United States. About 31 percent went to other Latin American and Caribbean destinations, 8 percent to Europe, and the remainder to other regions. Available Costa Rican data on total exports could not be disaggregated for exports to the shrinking CACM market and exports to the rest of the world. A further complication was the shift in tariff nomenclature in 1986, which makes comparison with previous years difficult. The available data do indicate several agricultural products with explosive growth. Exports of ornamental plants and flowers rose from $1 million in 1985 to $24 million in 1986, while fruit exports (other than bananas) rose from less than $10 million to $34 million over the same period.

The inability to obtain consistent data by product and market for the past several years, or to fully distinguish between maquila activity and products with substantial Costa Rican content, limited the team's ability to fully evaluate the impact, trends, and likely future course of Costa Rica's nontraditional exports. Nevertheless, it is clear that a major shift in the country's participation in the world economy is underway.

It is interesting to project nontraditional export growth through 1990 (see Table B-4). Based on the assumption of a steady 20-percent growth rate for nontraditional exports (significantly lower than the actual 1982-1987 trend) and the assumptions discussed earlier regarding traditional price trends, nontraditional products will represent more than half of total exports in 1990--up from 7 percent in 1980. This would be a structural change of great magnitude, substantially increasing the diversity of Costa Rica's economy and ending its dependence on the vagaries of world prices for primary agricultural products.

2.2 Import Performance

Due to Costa Rica's import substitution strategies and entry into the CACM, imports during the 1960s and 1970s were dominated by capital equipment, raw materials, and other inputs for industries producing for domestic and regional markets and operating behind high levels of protection from international competition. During the late 1970s, as manufacturing output stagnated, construction materials became more important in the import picture. From 1981-1985, capital equipment and raw materials continued to dominate imports, representing about three-quarters of total imports (Table B-5).

Table B-4. Costa Rican Past and Projected Balance of Payments
(as of September 1985 data), 1979-1990
(millions of dollars)

Sector	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Exports	942	1,001	1,003	869	870	956	918	1,010	1,130	1,256	1,392	1,537
Imports	1,397	1,528	1,213	894	991	1,101	1,037	1,063	1,134	1,255	1,396	1,547
Trade Balance	-455	-527	-210	-25	-121	-145	-119	-53	-4	1	-4	-10
Outstanding Debt	1,423	1,820	2,369	2,578	3,393	3,455	3,575	3,633	3,675	3,774	3,863	3,981
Debt Interest	110	178	307	342	356	314	326	344	346	352	360	368
Average Rate (%)	7.7	9.8	13.0	13.3	10.5	9.1	9.1	9.5	9.4	9.3	9.3	9.2
Trade/Debt Gap	-565	-705	-517	-367	-477	-459	-445	-397	-350	-351	-364	-378
Imports + Interest	1,507	1,706	1,520	1,236	1,347	1,415	1,363	1,407	1,480	1,607	1,756	1,915
A.I.D. Flows	16	14	13	51	212	174	197	148	171	120	100	80
GDP	4,025	4,501	2,701	2,507	3,051	3,407	3,434	3,681	3,960	4,284	4,654	5,065
Debt/GDP (%)	35.4	40.4	87.7	102.7	111.2	101.4	104.1	98.7	92.8	88.1	83.0	78.6
Interest/Exports (%)	11.7	17.8	30.6	39.4	40.9	32.8	35.5	34.1	30.6	28.0	25.9	23.9
Exports/GDP (%)	23.4	22.2	37.1	34.6	28.5	28.1	26.7	27.4	28.5	29.3	29.9	30.3
Imports/GDP (%)	34.7	33.9	44.9	35.6	32.5	32.3	30.2	28.9	28.6	29.3	30.0	30.5
Interest/GDP (%)	2.7	4.0	11.4	13.6	11.7	9.2	9.5	9.3	8.7	8.2	7.7	7.3
Trade Balance/GDP (%)	-11.3	-11.7	-7.8	-1.0	-4.0	-4.3	-3.5	-1.4	-0.1	0.0	-0.1	-0.2

Table B-5. Costa Rican Imports, c.i.f., 1981-1985
(millions of dollars)

Category	1981	1982	1983	1984	Preliminary 1985
Consumer Goods	252	167	215	244	265
Nondurables	165	134	168	171	189
Durables	87	33	48	73	77
Raw Materials	484	362	432	466	442
Agriculture	44	44	50	47	39
Manufacturing and Mining	393	293	344	395	361
Construction	46	25	37	34	42
Petroleum and Petroleum Products	205	189	184	163	161
Capital Goods	259	167	152	212	219
Manufacturing and Mining	79	42	53	69	72
Agriculture	14	10	16	19	19
Construction	18	9	18	26	19
Transport	66	61	31	50	58
Other	83	45	34	47	50
Other	14	9	11	18	23
Total Imports (c.i.f.)	1,213	894	993	1,102	1,109
Imports as Percent of Total					
Consumer Goods	21	19	22	22	24
Raw Materials	40	41	44	42	40
Petroleum Products	17	21	19	15	15
Capital Goods	21	19	15	19	20
Other	1	1	1	2	2
Total	100	100	100	100	100
Annual Percentage Change					
Consumer Goods	-35	-34	29	13	9
Raw Materials	-14	-25	19	8	-5
Petroleum Products	-10	-8	-3	-11	-1
Capital Goods	-20	-35	-9	39	3
Total	-21	-26	11	11	1

Note: Numbers may not add to totals because of rounding.

Source: Central Bank of Costa Rica.

Just as export performance stagnated in the late 1970s due to diminishing opportunities for export substitution, so did Costa Rican imports from other CACM countries. Political and social disruption in the region exacerbated this tendency. During the financial crisis of the early 1980s, scarcity of foreign exchange and refusal of the Central American governments to pay accumulated deficit balances in the Central American Clearing House led to recurrent border closures and measures further restricting imports. Costa Rica's trade balance with CACM countries fell from $86 million in 1981 to $33 million in 1985 (see Table B-6). Total imports dropped in value from $1.5 billion in 1980 to less than $0.9 billion in 1982 (see Table B-5).

Total imports began increasing again in 1983, reaching $993 million in 1983 and $1.1 billion in 1985. The total has not yet reached its prerecession level, however. Because of decreasing prices, petroleum imports have declined in value from $205 million in 1981 to $161 million in 1985 (see Table B-5). That change, along with rising coffee prices, contributed to the overall improvement in Costa Rica's terms of trade from 103 in 1981 to 115 in 1985 (1974 = 100) and thus prevented larger trade deficits (see Table B-7). Imports of raw materials and capital goods, partly financed by Economic Support Fund (ESF) funds, have also resumed growth. As with consumer goods, however, imports have still not returned to prerecession levels.

2.3 Exchange Rates

Prior to the financial crisis of 1980, Costa Rica maintained a stable but slightly overvalued exchange rate. That crisis and the resulting collapse of prudent financial policy resulted in inflation and led to a highly overvalued colon in the 1980-1981 period. After vacillating between a fixed and a flexible rate system during this period, the Government of Costa Rica introduced a major reform in August 1982, intending to narrow the spread between the banking and free exchange rates.

Unification of exchange markets was reached in November 1983, and most exchange restrictions were eliminated by the end of that year. To prevent a significant divergence of the official and unofficial exchange rates, the official (interbank) rate is now adjusted frequently. This "crawling peg" system is necessary because Costa Rica's current inflation is generally higher than that of its major trading partners. Over time, the exchange rate appears to have remained only slightly overvalued (see Figure B-1). While some transactions are taking place in informal markets, the informal rate reportedly has generally not exceeded the official rate by more than 5 percent.

Table B-6. Costa Rican Trade with the Central American Region, 1981-1985
(millions of dollars)

Category	1981	1982	1983	1984	1985
Exports (f.o.b.)	238	167	198	193	131
By Commodity					
Agricultural Products	4	1	1	1	-
Manufactures	227	160	186	158	-
Chemicals	63	52	58	54	-
Machinery & Equipment	47	31	34	32	-
Paper and Printing	13	11	14	10	-
Processed Foodstuff	23	12	12	14	-
Textiles and Leather	43	27	31	26	-
Wood Products	6	4	5	4	-
Other	33	23	33	19	-
Other not specified	8	7	11	35	-
By Destination					
El Salvador	44	33	42	45	47
Guatemala	76	64	89	76	39
Honduras	35	23	27	45	28
Nicaragua	84	47	41	28	17
Imports (c.i.f.)	152	112	120	115	99
By Commodity					
Capital Goods	2	5	7	3	-
Consumer Goods	68	49	57	60	-
Durables	11	6	8	9	-
Nondurables	58	43	50	51	-
Fuels and Lubricants	2	2	0	0	-
Raw Materials	73	55	53	51	-
Agriculture	11	10	8	7	-
Construction	3	3	-	2	-
Manufacturing and Mining	58	43	45	42	-
Other	6	1	3	1	-
By Origin					
El Salvador	37	23	30	31	33
Guatemala	65	56	59	59	49
Honduras	16	12	11	8	7
Nicaragua	34	22	20	16	10
Trade Balance	86	55	78	78	33

Note: Figures may not add to totals because of rounding.

Sources: Central Bank of Costa Rica and General Directorate of Statistics and Census.

Table B-7. Costa Rican Terms of Trade (1974 = 100), 1981-1985

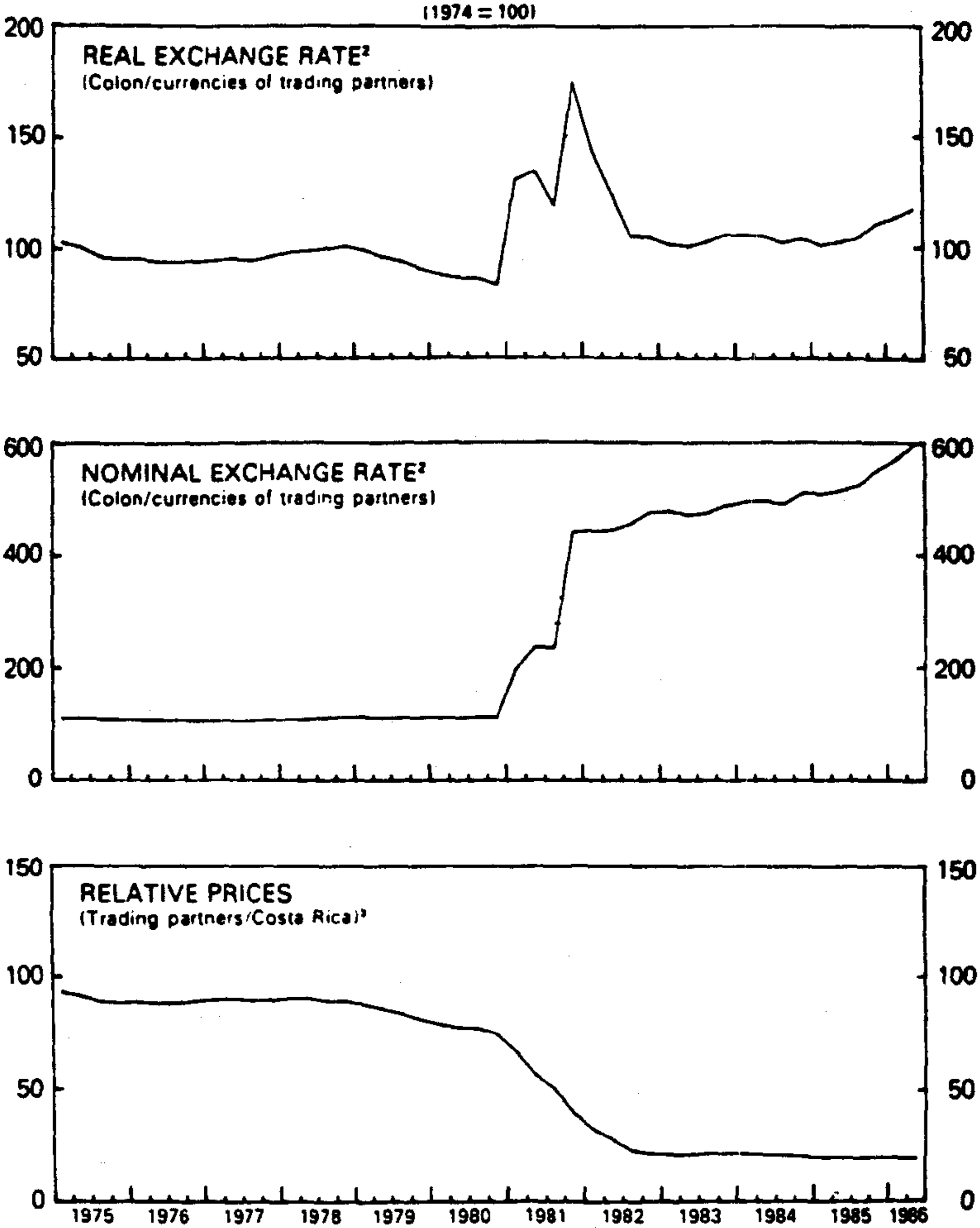
	1981	1982	1983	1984	1985
Total Value					
Exports	228	198	198	221	207
Imports	168	121	139	154	154
Volume					
Exports	137	122	123	135	123
Imports	104	78	92	104	105
Unit Value					
Exports	166	163	161	163	168
Imports	161	157	150	148	147
Terms of Trade	103	104	107	110	115

Source: Central Bank of Costa Rica.

2.4 Balance of Trade

Costa Rica's international trade position has improved considerably since the late 1970s, partly because of structural change in exports and partly because of the effect of recession on imports. The growth and diversification of nontraditional exports have helped to improve the international trade position, although the level of their contribution is unclear. Effective rates of protection remain high, however, and the bias is still particularly high against exports to countries outside CACM, as indicated in Table B-8. (Export bias is defined as the percentage by which value added of goods produced in Costa Rica and sold in the domestic market exceeds value added of the same goods when sold in the international market, including export subsidies.) Costa Rica's current account deficit has remained relatively stable since 1982, following a substantial improvement in 1982 due to the drop in imports. Overall, the terms of trade have been improving steadily over the 1980s (see Table B-7).

Figure B-1. Effective Exchange Rates and Relative Prices in Costa Rica, 1975-1986



[1] 1980 trade weights excluding oil and Nicaragua.
[2] An increase (decrease) in the index indicates a depreciation (appreciation) of the colon.
[3] Wholsale price index for Costa Rica and consumer price index for trading partners.

Sources: IMF, *International Finance Statistics* and IMF staff estimates.

Table B-8. Tariff Distortions in Costa Rica
Before (1985) and After (1986) Tariff Reform,
Selected Manufactured Products
(percentages)

Product	Effective Protection Rates		Bias Against Exports to Non-CACM Markets	
	1985	1986	1985	1986
Containers				
Paper & Cardboard	329	253	na	na
Plastic	30	31	205	196
Glass	12	14	548	408
Metal	152	104	-1,234	-1,952
Chemicals				
Fertilizers & Insecticides	36	29	na	na
Paint & Varnish	145	174	-202	-212
Medicine	12	12	85.6	83.6
Cosmetics	55	55	168.1	163.4
Other Chemical Products	194	162	na	na
Agroindustrial				
Canned Food & Marmalade	107	112	-217	-232
Shrimp	47	97	na	na
Vegetable Oils	20	62	na	na
Feed	66	43	na	na
Other Manufactured Products				
Manufactured Cloth	41	39	5	5
Garments	60	62	na	na
Lumber	79	85	-1	3
Publishing	55	36	-321	-310

Note: Negative signs mean that value added of exports to third-country markets is negative; "na" means not available.

Source: USAID/Costa Rica (1987d). Adapted from Prodesarrollo, La Reforma Arancelaria, el Caso de Costa Rica.

3. FISCAL SECTOR

Prior to 1979, Costa Rica's public revenues and expenditures appeared to be fairly well managed, with modest surpluses and only occasional deficits. Signs of burgeoning public enterprise subsidies and damage to the private productive sector and tax revenues were beginning to appear, however, even before the international commodity price crisis. Table B-9 demonstrates the increase in public sector expenditures, which was due to rapidly expanding subsidization of CODESA enterprises and the national banks, along with the decreasing rate of increase of tax revenues from private sources.

Significant fiscal imbalances in Costa Rica in the late 1970s and early 1980s contributed to an acceleration of inflation. The central Government deficit averaged 6.2 percent of GDP from 1978 to 1981, peaking at 8.0 percent in 1980 (see Table B-9). Serious imbalances were also present in the rest of the public sector, which includes decentralized agencies and state enterprises. The deficit of the consolidated nonfinancial public sector during the 1978-1981 period averaged 12.0 percent of GDP, with the figure rising from 9.0 percent in 1978 to 13.7 percent in 1981 (see Table B-9). Central Bank losses--equivalent to 5.6 percent of GDP in 1982--exerted further upward pressures on the price level; these losses resulted largely from the use of multiple exchange rates.

With a change in Costa Rica's administration in 1982, fiscal policy began to improve. Comparing 1978-1981 data with 1982-1983 data shows that the central Government deficit was reduced from 6.2 percent of GDP to 3.5 percent of GDP, while the total deficit fell even more sharply, from 12.0 percent to an average of 6.1 percent (see Table B-10). Further improvements were recorded during the 1984-1986 period, when the central Government deficit averaged 2.8 percent of GDP and the total deficit averaged only 1.7 percent, indicating that the decentralized agencies and state enterprises were in surplus. The losses of the Central Bank were still significant, but they fell as a percentage of GDP from an average of 5.0 percent in 1984-1985 to 3.8 percent in 1986.

Looking more closely at the consolidated nonfinancial accounts (Table B-9), we see that their deterioration in the late 1970s and early 1980s was due not to an increase in current expenditures as a percentage of GDP (which peaked in 1978-1980 after rising during the 1970s) but rather to a relative decline in current revenues--especially in the decentralized agencies and state enterprises--and to a lesser extent to a relative increase in capital expenditures. Both the rise in capital expenditures and the maintenance of the ratio of current expenditures to GDP

Table B-9. Costa Rican Fiscal Data, 1978-1986
(millions of colones and percentage of GDP)

Item	1978	1979	1980	1981	1982	1983	1984	1985	1986
					Millions of Colones				
GDP	30,194	34,584	41,405	57,103	97,505	129,314	163,010	192,425	239,231
Consolidated Nonfinancial Public Sector									
Current Revenue	7,351	7,691	8,959	10,235	17,691	34,558	44,803	51,464	
Current Expenditure	7,195	8,133	9,808	12,412	20,122	29,538	36,762	43,287	
Current Surplus/Deficit	156	-442	-951	-2,177	-2,431	5,020	8,041	8,177	
Capital Revenue	0	47	73	298	213	114	80	106	
Capital Expenditure/Net Lending	2,869	3,827	4,624	5,838	6,257	9,737	10,757	12,118	
Overall Surplus/Deficit	-2,713	-4,222	-5,502	-7,807	-8,475	-4,603	-2,636	-3,835	-3,684
Statistical Discrepancy	0	-428	627	-310	-159	586	-453	120	
Financing	2,713	4,650	4,875	8,117	8,634	4,017	3,089	3,715	
External		1,937	2,176	1,493	-1,459	-341	1,460	699	
Internal		2,713	2,699	1,738	2,623	14,848	-471	-1,054	
Change in External Arrears		0	0	4,886	7,470	-13,767	2,100	-3,096	
Rescheduling		0	0	0	0	3,277	0	7,166	
					Percentage of GDP				
Current Revenue	24.3	22.2	21.6	17.9	18.1	26.7	27.5	26.7	
Current Expenditure	23.8	23.5	23.9	21.7	20.6	22.8	22.6	22.5	
Current Surplus/Deficit	0.5	-1.3	-2.3	-3.8	-2.5	3.9	4.9	4.2	
Capital Revenue	8.0	0.1	0.2	8.4	0.2	0.1	0.0	0.1	
Capital Expenditure/Net Lending	9.5	11.1	11.2	10.2	6.4	7.5	6.6	6.3	
Overall Surplus/Deficit	-9.0	-12.2	-13.3	-13.7	-8.7	-3.6	-1.6	-2.0	-1.5
					Millions of Colones				
Central Government									
Current Revenue	4,026	4,238	5,306	7,778	14,026	21,417	27,012	32,006	38,029
Tax	3,925	4,098	5,124	7,517	13,717	20,835	24,659	29,666	33,638
Non-Tax	101	140	282	253	309	582	2,353	2,339	4,391
Current Expenditures	4,276	5,153	6,676	9,663	15,072	20,973	26,586	30,144	36,058
Wages and Salaries	2,120	2,489	2,936	3,501	5,044	7,730	9,822	10,981	13,651
Goods and Services	233	311	303	426	669	1,163	1,460	1,803	2,012
Interest, Domestic Debt	227	397	544	459	400	1,351	1,772	1,833	3,207
Interest, External Debt	227	225	358	968	2,215	2,382	2,429	2,800	2,770
Transfers	1,469	1,730	2,535	2,949	6,651	8,347	11,103	12,727	15,218
Exchange Subsidies	0	0	0	360	93	0	0	0	0
Current Surplus/Deficit	-250	-914	-1,370	-893	-1,046	464	426	1,862	1,171
Capital Expenditures	1,208	1,477	1,930	2,106	2,212	5,071	5,392	5,802	9,417
Overall Surplus/Deficit	-1,458	-2,391	-3,300	-2,999	-3,258	-4,627	-4,966	-3,940	-8,246
					Percentage of GDP				
Current Revenue	13.3	12.3	12.8	13.6	14.4	16.6	16.2	16.6	15.9
Tax	13.0	11.8	12.4	13.2	14.1	16.1	15.1	15.4	14.1
Non-Tax	0.3	0.4	0.4	0.4	0.3	0.5	1.1	1.2	1.8
Current Expenditures	14.2	14.9	16.1	15.2	15.5	16.2	16.3	15.7	15.4
Wages and Salaries	7.0	7.2	7.1	6.1	5.2	6.0	6.0	5.7	5.7
Goods and Services	0.8	0.9	0.7	0.7	0.7	0.9	0.9	0.9	0.8
Interest, Domestic Debt	8.8	1.1	1.3	0.8	0.4	1.0	1.1	1.0	1.3
Interest, External Debt	0.8	0.7	0.9	1.1	2.3	1.0	1.5	1.5	1.2
Transfers	4.9	5.0	6.1	5.2	6.8	6.5	6.8	6.6	6.4
Exchange Subsidies	0.0	0.0	0.0	0.6	0.1	0.0	0.0	0.0	0.0
Current Surplus/deficit	-9.8	-2.6	-3.3	-1.6	-1.1	0.4	0.3	1.0	0.5
Capital Expenditures	4.0	4.3	4.7	3.7	2.3	3.9	3.3	3.0	3.9
Overall Surplus/Deficit	-4.8	-6.9	-8.0	-5.3	-3.3	-3.6	-3.0	-2.0	-3.4

Source: Central Bank of Costa Rica.

in the face of deteriorating revenue performance were financed to a substantial degree by external borrowing, much of it from commercial banks at variable interest rates. Net external borrowing by the consolidated nonfinancial public sector peaked at 5.6 percent of GDP in 1979.

Table B-10. Nonfinancial Public Sector Deficits, 1978-1981 to 1984-1986 (percentage of GDP)

Category	1978-81	1982-83	1984-86
Total Deficit	-12.0	-6.1	-1.7
Central Government	-6.2	-3.5	-2.8
Rest of Public Sector	-5.8	-2.6	+1.1

The improvement in the fiscal accounts beginning in 1982 was due to a combination of factors. Current revenues of the central Government rose from 13.6 percent in 1981 to an average of 17.0 percent during the 1983-1985 period (see Table B-11). In the rest of the public sector, current revenues experienced a dramatic 1-year improvement between 1982 and 1983, rising from 3.7 percent of GDP to 10.1 percent. Current expenditures of the nonfinancial public sector showed a slight relative increase from 21.2 percent of GDP in 1981-1982 to 22.6 percent in 1983-1985, but remained below their 1978-1980 average of 23.7 percent. Capital expenditures declined sharply from an average of 10.5 percent of GDP during 1978-1981 to an average of 6.7 percent during 1982-1985, accounting for a significant share of the overall fiscal improvement, but at some cost to future economic growth.

Several changes have occurred during the 1980s in the structure of Costa Rica's tax revenues. Table B-12 shows that the most significant change has been the decline in the relative importance of export taxes, from an average of 31.9 percent of central Government revenues during 1981-1982 to a 14.8-percent average in 1984-1985. The share of income taxes also fell between these periods, from an average of 20.5 percent to an average of 18.0 percent. At the same time, the share of import taxes rose from a 10.0-percent average to a 19.2-percent average, and that of sales and selective consumption taxes increased from a 35.1-percent average to a 44.7-percent average.

Table B-11. Summary Operations of the Costa Rican Government Central Administration, 1981-1985 (percentage of GDP)

Item	1981	1982	1983	1984	Prelim. 1985
Total Revenue	13.6	14.4	16.5	17.1	17.5
Taxes on International Trade	5.5	5.9	6.1	5.3	5.9
Taxes on Imports	1.6	1.1	1.9	2.6	3.5
Taxes on Exports	3.9	4.8	3.9	2.4	2.3
Other	-	-	0.3	0.2	0.1
Total Expenditures	18.9	17.7	20.1	20.2	19.6
Current Expenditures	15.2	15.5	16.3	16.8	16.4
Capital Expenditures	3.7	2.3	3.9	3.4	3.2
Current Account Deficit	-1.6	-1.1	0.3	0.3	1.0
Overall Deficit	-5.3	-3.3	-3.6	-3.1	-2.1
Financing (net)	5.3	3.3	3.6	3.1	2.1
Domestic	2.8	1.0	1.9	1.2	-0.4
External	2.5	2.3	1.8	1.9	2.5
Net Disbursements	1.6	1.3	1.5	1.6	2.2
Interest in Arrears	0.9	1.0	0.2	0.3	0.3

Table B-12. Percentage Distribution of Costa Rican Central Government Tax Revenues, 1981-1985

Tax	1981	1982	1983	1984	1985
Direct Taxes	22.6	23.4	25.1	21.8	18.9
Income and Profit	19.8	21.2	22.9	19.1	16.9
Payroll, Property	2.8	2.2	2.2	2.7	2.0
Indirect Taxes	77.4	76.6	74.9	78.2	81.1
Sales and Selective Consumption	35.8	34.4	36.9	44.5	44.9
Imports	12.0	7.9	11.8	16.9	21.4
Exports	29.6	34.2	24.2	15.5	14.1
Other Taxes on International Trade	0.1	0.1	2.0	1.3	0.7
Total	100.0	100.0	100.0	100.0	100.0

In examining the pattern of Government expenditures by function, the team found that the economic crisis of the 1980s produced some significant shifts in the relative importance of key ministries, as measured by their spending levels. Table B-13 shows that the most significant relative increase was in expenditures by the Ministry of Finance, which rose from 19.8 percent of total central Government spending in 1975 to 30.2 percent in 1980 and 29.8 percent in 1985. Most of these expenditures consisted of debt service payments (14.0 percent in 1975 and 21.0 percent in 1985), with external debt overtaking internal debt in importance during this period. Also increasing in relative importance was spending by the Ministry of Labor and Social Security (5.7 percent to 7.2 percent). Ministries whose relative shares declined between 1975 and 1985 include Education (29.6 percent to 22.2 percent), Public Works (17.0 percent to 14.8 percent), and Health (5.8 percent to 3.7 percent), although part of these declines may be attributable to ministerial reorganizations.

However, the data in Table B-13 on the functional distribution of central Government expenditures give a misleading picture of the pattern of overall Government spending because they exclude spending by autonomous agencies, state enterprises, local governments, and other public entities. A more complete picture of public sector expenditures is presented in a recent study by Thelmo Vargas (1987), which provides data on the distribution of spending by what is called the "consolidated public sector." Unlike more usual definitions of total public sector spending, Vargas' presentation includes the public financial sector and, at least for purposes of showing the functional distribution of expenditures, does not make allowances for intragovernmental transfers and other adjustments (e.g., to show only the operational surpluses or deficits of state enterprises). As a result, the "total expenditure" figures tend to be about twice as high as those for the consolidated nonfinancial sector as defined by the IMF (see Table B-9). Nevertheless, they are useful for showing shifts in the composition of public sector outlays over the last decade.

The functional expenditure data collected by Vargas are shown in Table B-14, where they are grouped under an IMF classification scheme using four broad categories: general services, social services, economic services, and financial services. In broad terms, the relative importance of general services changed little between 1975 and 1985, averaging 5 percent during this period. The relative importance of social services spending, however, declined from 45.7 percent to 36.2 percent, with the spending shares of health and education experiencing significant declines (as was the case for central Government spending only), while that of social assistance increased. The share of economic services spending stayed fairly constant, in the 19-20 percent

Table B-13. Costa Rican Central Government Spending by Functional Category, 1975, 1980, and 1985

Category	Millions of Colones			Percentage Distribution		
	1975	1980	1985	1975	1980	1985
Legislative Assembly	19.3	31.9	173.5	0.7	0.4	0.5
Controller General's Office	14.8	37.2	237.3	0.5	0.4	0.7
Office of the Presidency	-	57.0	156.5	-	0.6	0.4
Ministries						
Presidency	34.5	-	418.7	1.2	-	1.2
Government	169.1	220.0	994.5	5.9	2.5	2.8
Foreign Relations	22.9	66.1	304.6	0.8	0.7	0.8
Public Safety	70.5	213.2	895.7	2.5	2.4	2.5
Finance	568.4	2,707.8	10,718.0	19.8	30.2	29.8
(Debt Service)	(403.0)	(1,552.0)	(7,558.0)	(14.0)	(17.3)	(21.0)
Agriculture	84.1	264.1	1,261.6	2.9	2.9	3.5
Economy and Trade	20.2	43.2	107.0	0.7	0.5	0.3
Public Works	487.3	1,414.6	5,328.8	17.0	15.8	14.8
Education	850.6	2,298.0	8,006.5	29.6	25.6	22.2
Health	166.3	345.1	1,321.8	5.8	3.8	3.7
Labor and Social Security	162.2	493.1	2,593.6	5.7	5.5	7.2
Culture, Youth, and Sports	22.3	90.3	382.1	0.8	1.0	1.1
Justice	-	92.7	498.2	-	1.0	1.4
Planning	-	-	45.1	-	-	0.1
Industry, Energy, and Mines	-	-	89.5	-	-	0.2
Judiciary	101.7	302.0	1,277.5	3.5	3.4	3.5
Supreme Electoral Tribunal	15.2	53.4	489.0	0.5	0.6	1.4
Specific Projects	3.4	242.8	709.6	0.1	2.7	2.0
Transfers	56.9	-	-	2.0	-	-
Total	2,869.7	8,971.6	36,009.1	100.0	100.0	100.0

Source: Vargas (1987, 14-15).

range, but within this category there was a sharp increase in relative spending for agriculture (from 1.8 percent to 8.1 percent) and a relative decline in the infrastructure categories. Financial services spending increased in relative importance from 29.1 percent to 38.5 percent, with almost all of the increase accounted for by debt servicing.

Table B-14. Functional Distribution of Total Costa Rican Public Sector Spending, 1975, 1980, and 1985 (percentages)

Function	1975	1980	1985
General Services	5.5	4.8	5.2
General Administration	2.4	2.2	2.4
Defense	1.3	1.0	1.1
Other	1.8	1.6	1.7
Social Services	45.7	43.4	36.2
Education	15.4	13.7	11.2
Health	15.7	14.7	9.2
Social Assistance	5.9	7.1	8.3
Housing, Water, Sewerage	3.5	2.9	2.8
Other	5.2	5.0	4.7
Economic Services	19.7	18.7	20.1
Agriculture and Irrigation	1.8	5.4	8.1
Transport	8.7	5.8	5.8
Communications	3.1	2.3	2.0
Energy	5.7	4.3	3.7
Other	0.4	0.9	0.5
Financial Services	29.1	33.0	38.5
Banking, Insurance, Other	16.5	13.2	17.0
Debt Servicing	12.5	19.8	21.5
Total	100.0	100.0	100.0

Source: Vargas (1987).

4. FINANCIAL SECTOR

The Costa Rican financial sector is characterized by significant state intervention at all levels. Commercial banking is largely state-owned, although private banks have recently expanded their field of operations. Domestic credit and interest rates are also state-controlled, although there has been a recent trend toward private sector-oriented credit policies. Finally, most external debt has been contracted by the public sector, with the private sector borrowing relatively little abroad. The following sections treat these issues in more detail.

4.1 International Capital Flows

4.1.1 Official Transfers

Since 1980, an external debt reaching approximately $4 billion and the resulting financial outflows for interest payments have created a dependency by Costa Rica on A.I.D. and other international donor funding. Official transfers, largely from A.I.D., have become an important element of the external assistance provided to Costa Rica; these transfers have risen rapidly from negligible amounts in 1981-1982 to almost 5 percent of GDP by 1983 (see Section 4.1.3).

4.1.2 Capital Account

The positive impact of the Cash Transfer program on the 1980-1982 financial crisis was almost immediate. After a period characterized by net capital outflows due to a decline in private sector confidence and curtailment of foreign commercial bank lending, 1983 witnessed a net capital inflow. This reversal was due to the Cash Transfer program, the U.S. Caribbean Basin Initiative, and the rescheduling of debt service obligations to bilateral creditors and commercial banks (Table B-15).

In 1984, capital inflows dropped sharply despite significant commercial bank debt relief from the previous year's rescheduling agreement. The reasons included (1) a slowdown in official disbursements, (2) Costa Rica's inability to secure a rescheduling agreement from the Paris Club, and (3) an increase in repayment obligations. Capital inflows to Costa Rica rose in 1985 because of a large inflow of private capital linked in part to (1) high domestic interest rates on foreign currency deposits, (2) higher

Table B-15. Costa Rican Balance of Payments, 1981-1985
(millions of dollars)

Item	1981		1982		1983		1984		Prel. 1985	
	$	% GDP	$	% GDP	$	% GDP	$	% GDP	$	% GDP
Current Account (including official trasfers)	-420	-16.0	-240	-9.2	-234	-7.4	-155	-4.3	-163	-4.5
Current Account (excluding official transfers)	-420	-16.0	-246	-9.4	-300	-9.5	-264	-7.4	-338	-9.3
Trade Balance	-205	-7.8	-24	-0.9	-131	-4.2	-105	-2.9	-176	-4.8
Exports	1,009		870		862		998		934	
Imports	-1,213		-894		-993		-1,102		-1,110	
Services (net)	-243		-251		-192		-191		-195	
Nonfactor (net)	77		96		122		123		118	
Factor (net)	-319	-12.2	-347	-13.3	-314	-10.0	-313	-8.8	-313	-8.6
Of Which, Official Interest	-308		-342		-328		-314		-308	
Private Transfers	27		30		23		32		32	
Offical Transfers	-0		6		46		109		176	
Capital Account	-50	-1.9	-74	-2.8	305	9.7	27	0.8	261	7.2
Public (net inflow)	231	8.8	128	4.9	219	7.0	91	2.6	146	4.0
Disbursements	330		191		312		201		248	
Amortization	-99		-63		-93		-110		-102	
Public (net refinancing of current obligations)	-211	-8.1	-217	-8.3	18	0.5	-76	-2.1	10	0.3
Rescheduling of Principal and Current Interest	-		-		192		154		302	
Amortization (unpaid)	-211		-217		-174		-229		-292	
Private and Net Errors and Ommissions[a]	-70		15		68		12		106	
Overall Balance	-470		-314		50		-128		99	
Accumulation (+) of Arrears	359		453		-1,070		175		-183	
Rescheduling of Arrears	-		-		749		-		109	
Special Bank Credit Facilities	-		-		204		50		75	
Net Official Reserves (increase -)	106		-129		58		-97		-100	
Net Use of Fund Resources	46		-10		99		-34		30	
Other Net Official Reserves	66		-13		-49		-63		-130	

[a]Includes SDR allocation, revaluation, and transactions with nonmonetary agencies.
Source: IMF (1986b, Appendix Table 41).

disbursements from multilateral agencies, (3) additional debt relief from commercial banks and bilateral creditors, and (4) disbursement of $40 million under the first World Bank Structural Adjustment Loan.

The international component of the Costa Rican banking system is flexible but potentially unstable because of external deposits of colones. Many businessmen have made colon deposits outside Costa Rica to avoid taxes on interest and profits. With a 50-percent domestic tax rate, the savings are significant on these deposits. Until recently, such deposits were held in Panama, but they are now moving to the Cayman Islands. A deposit in the Cayman Islands permits businessmen to guarantee letters of credit, which require a 50-percent surety in U.S. dollars. Export proceeds are also placed in the Cayman Islands, and there is no need for currency conversion.

The opportunity costs of this tax loophole are not great for U.S. dollar deposits because Cost Ricans would otherwise put their dollars in the United States. But allowing the loophole for colon deposits in Panama is costly in terms of forgone tax revenues for the Costa Rican budget.

4.1.3 External Debt

Costa Rica's external public debt increased 8 percent per year during the 1981-1985 period, from $2.8 billion to $3.7 billion, and at the end of 1985 amounted to 102 percent of GDP (see Table B-16). Debt servicing obligations rose 4 percent per year during the same period because of a decline in international interest rates and the substitution of concessional official borrowing and grants (mainly from the ESF program) for commercial bank debt. The debt service ratio remained fairly stable between 1981 and 1984 but rose sharply in 1985 as merchandise exports dropped. In 1985, the external debt service burden was eased substantially by debt rescheduling, dropping from 59 percent before rescheduling to 35 percent after rescheduling.

4.2 Domestic Financial Intermediaries

The financial sector in Costa Rica consists of the National Securities Exchange; the commercial banking system, including the Central Bank, state-owned banks, and private banks; private finance companies registered at the Superintendency of Banks; other financial institutions, mainly public sector entities with financial activities; private savings and loan associations and

Table B-16. Costa Rican External Public Debt Operations, 1981-1985
(millions of dollars)

Item	1981	1982	1983	1984	1985
Outstanding Debt (end of year)	2,760	2,962	3,407	3,455	3,694
Short-Term[a]	341	309	247[b]	284[b]	256[b]
Medium- and Long-Term[c]	2,419	2,653	3,160	3,171	3,438
Nonfinancial Public Sector	1,350	1,674	1,723	1,716	1,893
Financial Public Intermediaries	1,069	979	1,438	1,455	1,545
Net Drawings (medium- and long-term)	231	128	371	139	221
Disbursements	330	191	464[d]	251[d]	323[d]
Amortization[e]	-99	-63	-93	-112	-102
Contractual Debt Service	628	632	607	678	725
IMF	15	18	25	38	37
Repurchases	10	10	12	23	22
Charges	5	8	13	15	15
Other	613	614	582	641	688
Amortization[f]	310	280	267	339	394
Interest[f]	303	334	315	302	294
New Loans Contracted[g]	288	281	433	141	-
Outstanding Debt/GDP (%)	103	122	108	97	102
Net Drawings/GDP (%)	9	5	12	4	6
Debt Service Ratio Before Rescheduling[h] (%)	52	54	54	53	59
Debt Service Ratio After Reschedulingh (%)	52	54	36	41	35
Contractual Interest/Exports of Goods and Nonfactor Services (%)	25	29	29	25	25

[a]Includes debt to the IMF and short-term liabilities of the Central Bank.
[b]Excludes special credit facilities of foreign banks and all rescheduled debt, which are included in medium-term debt.
[c]Includes principal in arrears in 1981-1985 and rescheduled debt in 1983-1985. Also includes $111.8 million capitalization of interest in 1983.
[d]Includes $152 million, $50, and $75 million disbursement under special credit facilities of foreign banks in 1983, 1984, and 1985, respectively. In 1985 includes $28 million of short-term debt with Mexico converted into long-term debt.
[e]Excludes unpaid or rescheduled amortization.
[f]Includes unpaid or refinanced current amortization and interest.
[g]Excludes short-term and IMF loans and includes revolving trade-credit facility.
[h]As a percentage of exports of goods and nonfactor services.

Sources: Central Bank of Costa Rica; World Bank (1986a, Appendix Table 49); and IMF staff estimates.

nonregulated finance entities; and money lenders (USAID/Costa Rica 1987a). By the standards of developing countries, the Costa Rican financial system is well developed and sophisticated. It is dominated, however, by state-owned banks that often base decisions more on politics than economics.

Total bank credit expanded faster than the growth of money or quasi-money over the 1981-1982 period (Table B-17). During stabilization efforts begun in the second half of 1982, these trends reversed. Since then, continued efforts to stabilize the situation have led to an overall deceleration of bank credit expansion. The flow of loanable resources to the banking system has followed a path similar to that of nominal GDP.

This decline in credit expansion was eased by an improvement of the financial position of the nonfinancial public sector, which lowered its net indebtedness to the banking system in 1984 and 1985. Following a sharp drop in 1982 at the end of the financial crisis, credit to the private sector relative to GDP expanded during the next 3 years (Table B-17). But in 1985, its ratio to GDP was still below 1981 record levels. Total bank credit since the late 1970s has been dominated by changes in the counterpart of external payments arrears and by net operating losses of the Central Bank.

Using IMF estimates of actual arrears in Central Bank accounts, it appears that annual changes in the net domestic assets of the Central Bank have been influenced significantly by the extent to which external payment arrears have been reduced or accumulated. In the 1981-1982 period, most Central Bank losses originated in exchange rate guarantees and subsidies granted to both the public and private sectors. Since 1983, the main component of these losses has been interest paid on private debt contracted in the past by the Central Bank to finance the nonfinancial public sector.

4.3 Domestic Interest Rates

High inflation in the 1981-1982 period led to a sharp drop in real interest rates, which became negative by substantial margins (Figure B-2). As expected, private financial savings, including Government bond holdings of the nonbank private sector, plummeted in real terms during 1982. Their recovery and relatively stable position in the economy in 1983 and 1984 reflects the subsequent rise and stabilization of the real rate of interest. Variation in real interest rates generally was determined by fluctuations in inflation, as nominal rates remained relatively unchanged (Figure B-2). By mid-1982, the basic rate for

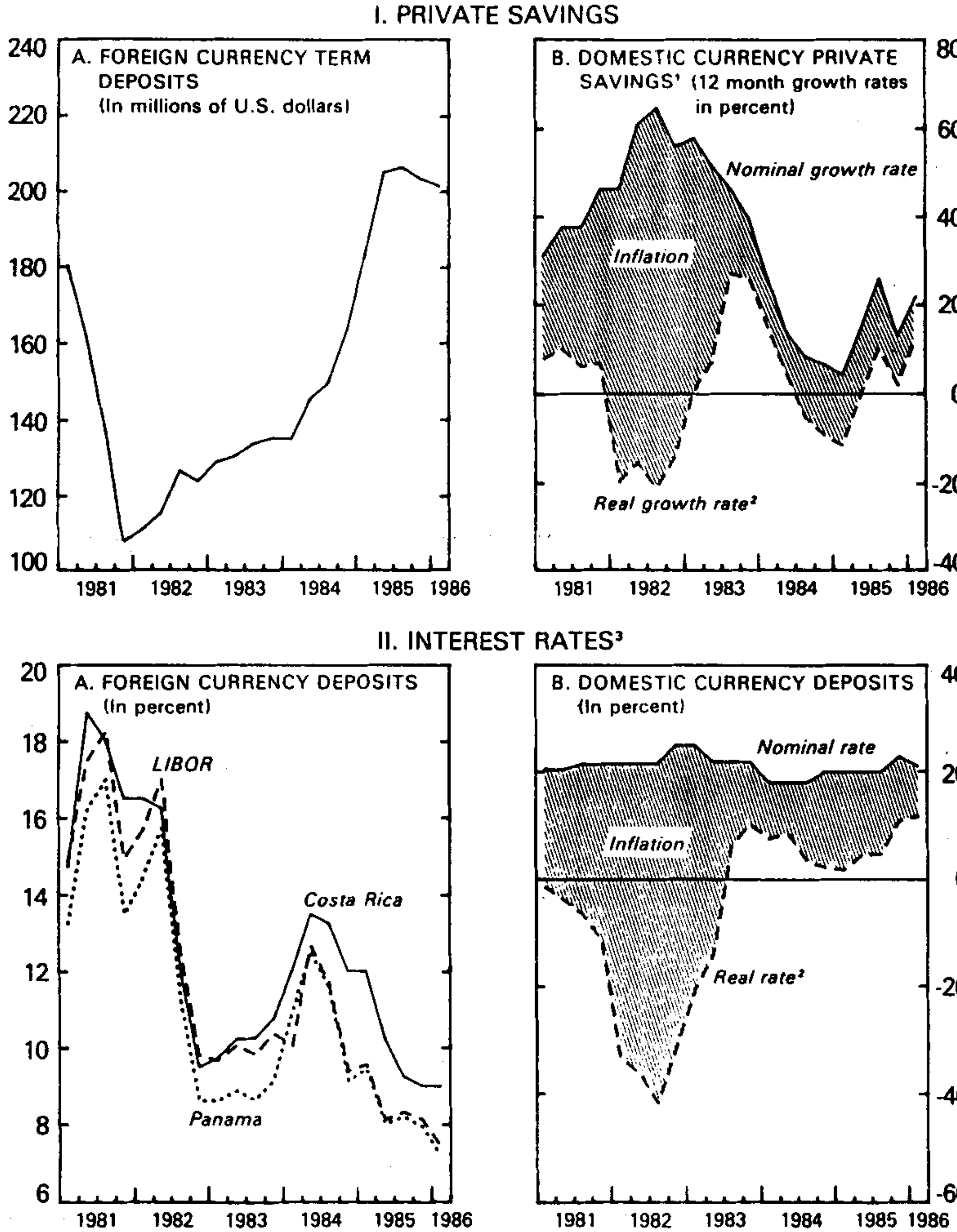
Table B-17. Summary Operations of the Costa Rican Banking System, 1981-1986[a]
(in millions of colones)

Item	1981	1982	1983	1984	1985	Prel. May 31, 1986
Central Bank						
Net International Reserves	-34.1	-46.1	-1.0	12.2	-11.2	-4.0
Public Sector (net)	12.7	-8.3	5.7	1.8	1.0	7.8
Banks	-7.5	-8.9	-3.9	-4.2	-1.8	-5.0
Trust Funds	-	-	-	-6.1	-10.5	-4.1
Stabilization Funds	-6.9	-11.9	-0.8	0.4	-1.1	2.5
Long-Term Liabilities	-2.5	-7.4	-12.5	-3.7	1-0.5	-11.2
Counterpart Arrears	29.5	64.4	-11.7	12.2	-12.7	2.2
Operating Losses	-	-	-	6.8	26.6	-
Other	17.2	10.9	22.2	5.0	-2.2	16.4
Currency Issue	8.4	9.3	4.9	1.7	5.4	4.6
Banking System						
Net International Reserves	-33.2	-46.0	4.5	-11.0	17.2	-0.2
Net Domestic Assets	62.9	105.3	38.2	26.6	11.8	31.2
Public Sector (net)	9.1	8.7	0.9	-2.9	-0.8	7.7
Private Sector	6.4	17.9	22.8	9.0	8.5	6.7
Trust Funds	-	-	-	-6.1	-10.5	-4.1
Counterpart Arrears	29.5	64.4	-11.7	12.2	-12.7	2.2
Other	17.9	14.3	26.2	14.2	27.3	18.7
Medium- and Long-Term Foreign Liabilities	2.4	8.8	12.4	5.2	11.6	10.9
Liabilities to Private Sector[b]	27.3	50.5	30.3	10.4	17.4	20.1
Money	18.5	23.5	13.4	5.9	5.3	12.1
Quasi-Money	8.8	27.0	16.9	4.5	12.1	8.0
Domestic Currency	17.1	24.2	16.6	3.3	6.9	5.9
Foreign Currency	-8.3	2.8	0.3	12.2	5.2	2.1
	Stocks, in Percentage of GDP[c]					
Net Credit to Public Sector	15.2	10.7	9.1	7.4[d]	5.9[d]	5.3[d]
Credit to Private Sector	21.8	16.1	17.6	18.9	19.1	17.1
Liabilities to Private Sector	36.3	34.8	36.7	36.5	36.6	36.5

[a]Accounts in foreign exchange valued at the average exchange rate for the relevant 12-month period ending December 31, except for May 1986, for which the 1985 average was used.
[b]In relation to the stock of liabilities to the private sector at the beginning of the period.
[c]Ratio of the average stocks at the beginning and end of the year in relation to GDP in the year.
[d]Excludes external debt of the nonfinancial public sector assumed by the Central Bank.

Source: IMF (1986b, Statistical Appendix Tables 15 and 35).

Figure B-2. Private Savings and Investment Rates in Costa Rica, 1981-1986



[1] Money plus savings and time deposits and stabilization bonds.
[2] Deflated by the consumer price index.
[3] Annual rates on 6-month deposits.

Sources: Central Bank of Costa Rica and IMF staff estimates.

6-month deposits to which other interest rates on the Costa Rican banking system were linked had risen to 21.5 percent in nominal terms, although this compared unfavorably with the 12-month increase in the consumer price index (see Section 4.4 below). This relationship reversed in 1983 as inflation dropped and to some extent stabilized (Figure B-2).

Subsidized credit is still expanding, as indicated in Table B-18. The subsidized rates charged by state-owned banks ranged from 8 to 17 percent (Table B-19). Interest rates paid on deposits and interest rates charged on nonsubsidized loans had generally increased by 1986 from low levels for state banks to a middle range for private banks and high values for private finance companies (Tables B-20 and B-21).

Private banks are much more efficient than state banks in Costa Rica. The intermediation cost (the difference between the average rate charged on loans and the average rate paid on deposits) was 11.26 percent in state-owned banks as compared with 3.94 percent in private banks during 1986. This translates to higher costs for borrowers and lower returns for depositors in state banks. It has been estimated that the cost of repeated trips to the bank, untimely disbursement of money, and other loan-related costs in state banks averaged 11.5 percent on an annualized basis and increased the effective cost of credit by 84 percent.

4.4 Inflation

As a result of curtailing imports and printing money to finance the budget deficit, Costa Rica experienced a sharp economic recession and triple-digit inflation in 1982. The average rate of inflation for that year was 90 percent as measured by the consumer price index (CPI), or 108 percent using the wholesale price index. As a result of more conservative financial policies, the CPI was only 33 percent in 1983 (Figure B-2 and Table B-22). Despite some loosening of financial policies, Costa Rica's inflation rate continued to decline, possibly as a result of tightening price controls, particularly for some staple goods. During the first part of 1985, inflation rose slightly, reflecting (1) relatively rapid depreciation of the colon during the last months of 1984, (2) relaxation of fiscal policies since late 1985, and (3) further adjustments in controlled prices. The rate of inflation began to accelerate in 1986.

Table B-18. Subsidized Credit Extended by Costa Rican State-Owned Banks Outstanding as of December 31 (millions of colones)

Credit Category	1984	1985	1986[a]
Cooperatives of Small Agricultural Producers	0.0	86.9	86.9
Credit to State-Owned Bank Employees	193.0	360.7	418.4
Emergencies	8.0	4.9	0.2
Forestry	8.8	8.6	7.6
Interdepartmental Loans	27.2	56.2	83.2
Rescheduled Loans	414.2	525.2	485.5
Rural Department of Banco Nacional			
Agriculture and Livestock	993.2	969.4	969.4
Small Industrial Producers	1.7	1.8	2.0
Rural Women and Youth Development Program	19.9	16.7	16.7
Self-Governing Campesino Communal Enterprises	0.0	1.0	1.0
Self-Governing Campesino Cooperatives	0.0	61.3	61.3
Small Farmers and Fishermen	2,021.4	1,671.2	1,671.2
Small Industrial Producers	476.8	652.1	797.0
Urban Development Program	199.6	133.7	99.2
Total	4,363.9	4,549.7	4,699.6

[a]As of September 30, 1986.

Source: Central Bank, as presented in USAID/Costa Rica (1987a).

Table B-19. Interest Rates Charged by Costa Rican State-Owned Banks on Subsidized Credit as of May 1984 and December 1986 (percentages)

Credit Category	1984 Interest	1984 Commission[a]	1986 Interest	1986 Commission[a]
Interest Rates Established by Law				
Forestry Activities	8	0	[b]	[b]
Discount of Collateral Paper	8	13.5	8	[c]
Self-Governing Campesino Communal Enterprises	8	4	8	[c]
Cooperatives of Small Agricultural Producers (ITCO Law)	6	6	6	6
Rural Women and Youth Development Program	12	0	12	3
Small Agricultural Producers	12	0	12	3
Small Industrial and Artisan Producers	12	0	17	0

[a]Annual commission.

[b]Forestry activities were transferred to the nonsubsidized credit category.

[c]A commission equal to the difference between the subsidized rate and the nonsubsidized rate that would be applicable to this activity.

Source: USAID/Costa Rica (1987a).

Table B-20. Interest Rates Paid on Deposits by State-Owned Banks, Private Banks, and Private Finance Companies in Costa Rica as of December 24, 1986
(percentages)

Item	State Banks	Private Banks	Private Finance Companies
Passbook Savings	8.0	[a]	[a]
Term Deposits			
1-Month Maturity	14.0-14.25	[a]	[a]
2-Month Maturity	12.0-16.0	[a]	[a]
3-Month maturity	15.0-18.75	[a]	[a]
6-Month Maturity	18.0-20.0	20.0-25.0	23.0-24.5
12-Month Maturity	18.0-21.0	21.0-26.0	23.0-26.7
24-Month Maturity	na	22.0-27.0	25.0-27.5

Notes: As of December 24, 1986, treasury bonds and Central Bank stabilization bonds with 180-day maturity offered 20.75 percent and 20 percent, respectively. The rates in each column are the lowest and highest rates paid as of December 24, 1986. Private finance companies are those registered at the Superintendency of Banks. "Na" means not available.

[a]Private banks and private finance companies are not allowed to accept passbook savings deposits and term deposits with maturities of under 180 days.

Source: Central Bank, as presented in USAID/Costa Rica (1987a).

Table B-21. Interest Rates Charged on Nonsubsidized Loans by State-Owned Banks, Private Banks, and Private Finance Companies in Costa Rica as of December 24, 1986, by Sector (percentages)

Sector	State Banks	Private Banks	Private Finance Companies
Agriculture			
Agricultural Product Marketing	24.5-26.5	23.5-29.5	23.5-33.0
Other		23.5-29.5	23.5-33.0
Short-Term	20.5		
Investment	21.5-24.5		
Livestock	na	23.5-29.5	23.5-33.0
Short-Term			
Cattle Raising and Fattening	23.0-24.5	na	na
Other	20.5-24.5		
Investment			
Cattle Breeding	20.5-22.5	na	na
Other	21.5-24.5		
Manufacturing	24.0-26.5	23.5-29.5	23.5-35.0
Construction	24.0-26.5	na	na
Housing	22.0-23.5	23.5-32.0	26.033.0
Other Activities[a]	27.0-28.5	28.0-35.0	28.0-33.0

Notes: The rates in each column are the lowest and highest rates charged as of December 24, 1986; private finance companies are those registered at the Superintendency of Banks; na means not available.

[a]Services, commerce, and personal credit.

Source: Central Bank, as presented in USAID/Costa Rica (1987a).

Table B-22. Price Indicators for Costa Rica, 1981-1986

Indicator	1981	1982	1983	1984	1985	July 1986
Consumer Price Index						
Average	37.1	90.1	32.6	12.0	15.0	11.1
End of Period	65.1	81.8	10.7	17.4	10.9	13.4
Wholesale Price Index						
Average	65.3	108.1	26.2	7.7	10.4	8.3
End of Period1	17.2	79.1	5.9	12.2	7.6	9.2
GDP Deflator	41.1	84.2	28.9	14.2	14.5	

Sources: Central Bank of Costa Rica and IMF staff estimates.

5. EMPLOYMENT, EQUITY, AND BASIC NEEDS

Standards of living in Costa Rica are quite high in comparison with other Latin American countries, especially in terms of social benefits. Any short-term improvement in living standards is likely to come from increases in employment and wages. Both jobs and social benefits have risen steadily and substantially since the crisis period of the early 1980s. Wages have recently surpassed peak levels of the late 1970s. The favorable employment patterns of the 1960s and 1970s appear to have recurred in the post-crisis 1980s. Economic growth, with the exception of the 1980-1982 financial crisis, has led to improved job opportunities, increased social services, and higher incomes and living standards (Fields 1986).

Many standard-of-living indicators in Costa Rica are closer to those of industrial market countries than to those of even "high-income oil exporters" or "upper middle-income" developing countries. For example, Costa Rica's 74-year life expectancy at birth equals that of Ireland, New Zealand, and Austria, and is only 4 years lower than the 78-year highest life expectancy rate of France and Australia. The infant mortality rate of 18 deaths per thousand births is significantly below that of Washington, D.C.

5.1 Employment[1]

1960-1973. To understand the negative impact of the 1980-1982 recession on Costa Rica's employment and income, one must examine the changes in the labor market that took place during the preceding period of sustained economic growth. Until 1973, the labor force grew roughly at an annual rate of 2.5 percent, and employment kept pace. Changes in occupational distribution indicated an improved wage position because those occupational categories with the highest median incomes rose the fastest (Table B-23). There was a shift from lower paying "self-employed" and "nonremunerated family work" into higher paying "wage earner" categories, representing higher earnings for the average Costa Rican breadwinners. In 1963, wage earners made up 66 percent of labor force. By 1973, the share had risen to 74 percent, indicating that the economic growth of the 1960s and early 1970s had brought Costa Ricans better jobs. This was reinforced by a sectoral shift of employment from low-paying agriculture into higher paying sectors (Table B-24). The highest paying sectors exhibited the highest growth rates in employment, indicating that economic growth had led to relatively more higher paying jobs for Costa Ricans.

Public sector employment also rose between 1963 and 1973, from 13 to 15 percent of the total, and public sector wages rose to roughly twice the level of the private sector by 1983 (see Table B-25). These facts reflect widespread increases in human capital as measured, for example, by rising literacy rates and education levels (see Table B-26).

1973-Present. Available data on employment and labor indicators continued to show steady improvements until the 1980-1982 financial crisis. Unemployment rates dropped to below 5 percent between 1977 and 1979, despite a high labor force growth rate of 4 percent. Underemployment, at 9 percent in 1976, dropped to below 8 percent in 1977 and 1978. After a 13-percent decline in real wages between 1972 and 1975 due to the oil price shock[2] and subsequent inflation, real wages grew by 30 percent during the second half of the 1970s. During the latter 1970s, Costa Ricans were again participating in growth by enjoying higher wages. Public sector employment continued to grow faster than private sector employment, rising from 15 percent of total employment in 1975 to 18.5 percent in 1979. A strong labor union in the public

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[1]Data from Fields (1986), except as noted.

[2]This shock was dampened by the subsequent rise in coffee prices.

Table B-23. Changes in Occupational Distribution of Employment in Costa Rica Between 1963 and 1973

Occupational Category	Percentage Change in Employment 1963-1973	Approximate Median Income 1973 (colones)
Professional and Technical Workers	+126	2,600
Managers	+88	1,800
Office Workers	+62	1,600
Storekeepers and Vendors	+52	1,200
Farmers, Cattlemen	+11	na
Other	+83	700
Total	+48	800

Source: Adapted from Fields (1986, 10).

Table B-24. Changes in Employment by Economic Sector Between 1963 and 1973

Sector	Percent of Employment 1963	Percentage Change in Employment 1963-1973	Mean Income 1971 (colones)
Agriculture	49	+10	793
Mining	1	+40	1,372
Manufacturing	11	+54	1,213
Construction	6	+68	1,203
Commerce	10	+75	1,539
Services	17	+75	1,624
Other	6	+228	1,134
Total	100	+48	

Source: Adapted from Fields (1986, 9).

Table B-25. Average Real Wages in Costa Rica, 1978-1983
(in colones)

Year	Private Sector	Public Sector
1979	1,703	2,526
1980	1,282	2,359
1981	1,172	2,257
1982	985	1,684
1983	1,027	2,189

Source: Adapted from Fields (1986, 23).

Table B-26. Changes in Labor Market Conditions:
Income Distribution in Costa Rica, 1963 and 1986
(percentages)

Indicator	1963	1986
Unemployment Rate	6.9	6.2
Composition of Employment		
Activity Status		
Wage Earners	66	75
Nonremunerated Family Workers	10	5
Occupational Distribution		
Professional, Technical, Managerial, and Office Workers	11	35
Industrial Distribution		
Employed in Manufacturing	12	16
Employed in Agriculture	50	28
Public/Private		
Public Employment	13	19
Educational Composition		
Without Education	15	3[a]
Secondary or Higher Education	11	59[a]
Real Wage (index)	100	160[b]
Income Inequality (Gini coefficient among households)	0.52[a]	0.47
Absolute Poverty		
Poor, Poverty Line = 250 Constant (1971) Colones per Household	20[c]	10
Poor, Poverty Line = 500 Constant (1971) Colones per Household	65	30

[a]Percent of employed population.
[b]Approximate.
[c]Data pertain to 1961.

Source: Adapted from Fields (1986, 42).

sector successfully maintained its faster growth and a wage level double that of the private sector.

This sustained prosperity came to a halt with the financial crisis. By mid-1982 real wages had dropped to 46 percent of their mid-1979 level. The growth rate of employed labor declined and the rate of open unemployment increased from 4.5 percent in early 1979 to 9.5 percent in early 1982. The average product per worker decreased considerably during the 1979-1982 period, although employment levels were maintained. The resulting lower standard of living produced by the drops in real wages and income reflected the high social costs of the financial crisis to low- and middle-income Costa Ricans.

During the crisis, the employment mix favored lower paying jobs and reversed the improvement in occupational distribution that had been taking place for two decades (Fields 1986, 27). While personal services accounted for 60 percent of employment growth, the manufacturing, construction, and basic services sectors registered substantial lost jobs during the crisis. The occupational mix indicated that the top occupational classes were losing importance, reaching their lowest levels in 1982. The informal sector increased both absolutely (by 20,000 people) and relatively (from 27.7 percent of the total in 1979 to 29.2 percent in 1982).

Beginning in the latter half of 1982, employment and wages again began rising (Table B-27), and unemployment and underemployment rates began dropping (Table B-28). The labor market reverted back to the trends and patterns experienced during the 1960s and 1970s.

Table B-27. Real Minimum Wage Index in Costa Rica, 1981-1985
(nominal minimum wages deflated by Consumer Price Index)
(1975=100)

Item	1981	1982	1983	1984	1985
Real Minimum Wage Index	113	105	121	127	132
Total Employment	751	777	805	837	-
Private Sector	612	642	632	649	681

Table B-28. Unemployment and Underemployment in Costa Rica, 1982-1986

Year	Number of Unemployed (thousands)	Unemployment Rate (percent)	Underemployment Rate (percent)
1982	79	9.5	11.8
1983	73	9.0	11.1
1984	65	7.8	9.0
1985	54	6.3	-
1986	-	6.1	-

Source: Calculated from National Household Survey and adapted from Fields (1986, 39).

5.2 Equity and Basic Needs

Income inequality declined during the 1960-1980 period as the income shares of Costa Rica's poorest groups increased while those of the richest groups declined (Fields 1986). The Gini coefficient, the most commonly used income inequality indicator, dropped from 0.52 in 1961 to 0.45 in 1971 and reflected the most improvement and the most equitable income distribution in Latin America. As indicated in Table B-26, absolute poverty was also reduced by half, from 20 to 10 percent, if the poverty line is drawn at 250 constant (1971) colones per family; if a poverty line of 500 colones per family is used, it fell from 65 to 30 percent.

Costa Rica's economic performance over the last three decades, including the crisis and post-crisis period, is well documented. Its improvements are among the world's best. This is particularly remarkable for a country with a 1985 per capita GDP of only $1,300. Costa Rican achievements can be summarized as follows.[3]

-- Life expectancy at birth rose from 64 years in 1965 to 74 years in 1985.

[3]Most of these indicators are quoted in a letter to Minor Sagot of the Economic Affairs Office of USAID/Costa Rica from Jorge Guardia Quiros of COUNSEL (Consultores Economicos y Legales). The original sources are the Asociacion Demografica Costarricense and the Ministerio de Salud.

-- The infant mortality rate per thousand live births dropped from 76.2 in 1960 to 61.5 in 1970, 19.1 in 1980, and 18.6 in 1984.

-- Immunization coverage has increased.

-- Oral rehydration packet distributions rose from 1,500 packets in 1969 to 10,438 packets in 1984.

-- Primary school enrollment ratios (percent of children in primary school relative to the total 7-12 year old population) rose from 95 percent in 1960 to an average of about 103-104 percent in the 1980s.

-- Primary school retention rates rose from 93 percent in 1960 to 95 percent in 1970 and 97 percent in 1983.

-- The percentage of the population with access to potable water rose from 75 percent in 1967 to 87 percent in 1981 and 92 percent in 1983.

-- The percentage of the population with access to a sewage system rose from 38 percent in 1967 to 89 percent in 1983.

-- Electricity coverage rose in urban areas from 98 percent in 1982 to 100 percent in 1983, and in rural areas from 73 percent in 1978 to 80 percent in 1983.

-- The percentage of women with access to a family planning program rose from 45.5 percent in 1973 to 88.4 percent in 1982.

-- Crude birth rates per thousand population dropped from 47.5 in 1960 to 31.3 in 1981 and 29.9 in 1983.

-- Housing starts dropped from 14,460 in 1983 to 6,000 in 1984, but the level of housing is considered by one World Bank analyst to be the best in Latin America. Housing is, however, an important political issue.

-- Membership in cooperatives rose from 81,200 members in 1973 to 176,634 in 1981 and 268,000 in 1985.

-- Labor union membership rose from 71,355 members in November 1983 to 150,000 in May 1985.

The public sector service delivery system appears to have been resilient even in economic downswings, maintaining or improving upon past performance. For example, consider Costa Rica's water supply and sanitation program, which provides the highest coverage of such systems in any Central American country. In urban areas, water supply coverage was maintained at 100 percent from 1980 to 1986, with approximately 101,000 additional persons being served. Likewise, urban sanitation coverage remained at 99 percent, with approximately 100,000 additional persons added to the system. Over the same period, water supply coverage in rural areas increased from 79 percent to 100 percent and sanitation coverage from 87 percent to just over 94 percent, representing increases of 470,000 and 299,000, respectively, in the number of persons served.

6. AGRICULTURE

Agriculture plays a critical role in the Costa Rican economy. It accounts for 60 percent of its total exports, 30 percent of its employment, and 25 percent of its total output. A downturn in coffee prices contributed to the recession and financial crisis of the early 1980s. Movement away from reliance on traditional exports--particularly coffee, sugar, bananas, and beef--represents a major effort in Costa Rica's structural adjustment program. However, the country remains vulnerable to downturns in world markets for the traditional exports.

As in "import substitution" manufacturing, many agricultural activities, including production of basic grains, have been protected by credit subsidies and other concessions. These distortions have contributed to misallocation of Costa Rica's scarce resources to production activities with questionable comparative advantage (e.g., rice production).

Policy reform, including the removal of rice from the Costa Rican grain marketing parastatal (CNP), has helped to lessen some economic policy distortions; however, many remain, and their reduction or removal remains part of Costa Rica's continuing policy reform effort. There appears to be much export potential in numerous nontraditional agricultural activities, including African palm, macadamia nuts, pineapples, and flowers. Output of these activities grew slowly until 1985, when it accounted for 8 percent of agricultural production; production has recently begun to grow at a higher rate.

Ironically, one of the stated purposes of the A.I.D.-funded agricultural college (EARTH) was to achieve self-sufficiency in agricultural commodities grown in the tropical areas. This is inconsistent with the current overall outward-looking strategy now being stressed by the Mission.

7. CONSUMPTION AND SAVINGS TRENDS

The impact of Cash Transfer programs on host country consumption and savings patterns is primarily long-term and indirect. Influences on consumption and savings come from A.I.D.-encouraged policy reforms and structural adjustments that create an environment for future stable growth. Through the improvement of private sector savings and investment levels, the need for future external assistance is reduced.

A.I.D. has been able to encourage a relative shift from consumption to savings in Costa Rica in two ways. First, the use of conditionality associated with Cash Transfers helped effect a shift of consumption and credit from inefficient public enterprises and to encourage more realistic public enterprise pricing. Second, discussions with the Central Bank led to a reduction of interest-rate regulations for the banking system, allowing a greater role for market forces in establishing interest rates.

Table B-29 shows trends in Costa Rica's savings and investment indicators. Gross national savings as a percent of GDP improved dramatically in 1983 because of an improvement in the operations of the nonfinancial public sector in the context of the A.I.D.-encouraged adjustment program and increases in real interest rates. The savings rate has continued to rise since then. Between 1980 and 1985 consumption as a percent of GDP declined from 82.5 to 77.6 percent. Nearly all the decrease was absorbed by the private sector.

Table B-29. Gross Consumption and Savings Trends in Costa Rica, 1978-1986 (percentage of GDP)

Item	1978	1979	1980	1981	1982	1983	1984	1985	1986
Savings	13.1	11.4	11.9	6.6	6.5	11.9	13.6	14.0	16.8
Private	12.6	12.7	14.2	10.5	9.0	7.9	8.0	8.0	na
Public	0.5	-1.3	-2.3	-3.8	-2.5	4.0	5.6	6.0	na
Consumption	na	na	na	82.4	80.7	77.8	74.6	77.6	na
Private	na	na	na	67.5	67.5	63.0	59.7	62.2	na
Public	na	na	na	15.0	13.2	14.8	15.0	15.4	na

Note: "Na" means not available.

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